COMPANY ACCOUNTING

A TREATISE ON THE ACCOUNTS OF
LIMITED COMPANIES FOR ACCOUNTANTS
SECRETARIES, AND STUDENTS

BY

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PREFACE

THE purpose of this book is to describe in the clearest manner the principles of company accounting. Students of accounting soon learn that it is in the application of the principles that real learning is acquired, and I have accordingly illustrated the text with a profusion of examples. Most of the illustrations are actual examination questions taken from papers set in recent years by the Institute of Chartered Accountants in England and Wales, or by the Society of Incorporated Accountants and Auditors, with answers by myself or colleagues engaged in the preparation of candidates for those examinations. The illustrations are therefore of real worth, both from the practical and the theoretical aspects.

In writing a book of this nature, I have had to assume that readers will be well versed in the theory of book-keeping before studying company accounting, and no attempt has therefore been made to describe the theory of double entry.

It has been my aim to prepare readers to deal with company accounting as it has to be dealt with in practice and in examinations, and I therefore avoid abstruse dissertations. Likewise, I have confined the text to accounting, only mentioning statutory returns where they bear on the accounts.

Reproduction of general forms does not seem to me to be necessary; students will find them in the more general textbooks.

H. A. R. J. WILSON.

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INSET

CONSOLIDATED STATEMENT . *facing* p. 366

COMPANY ACCOUNTING

CHAPTER I

INTRODUCTION

A COMPANY registered under the Companies Act, 1929, or any of the Companies Acts consolidated therein, is a creation of law, whereby a number of individuals can band themselves together, by means of certain formalities, into an entity separate from themselves.

In the case of a public company, the minimum number of persons is seven; in the case of a private company it is two. [A private company is one which by its Articles of Association (its regulations) restricts the right to transfer shares, prohibits any invitation to the public to take up shares or debentures, and restricts the number of its members to fifty, excluding employees and past employees who were members while employees, and have been members continuously since.] The persons who wish to form a company subscribe a document called the Memorandum of Association, in which are set out the name of the company, whether its registered office will be in England or Scotland, the objects with which it is being formed, a statement that the liability of the members will be limited, and a statement of the amount of the nominal capital. This is the constitution of the company.

The rules for carrying on the company are then

set out in Articles of Association, likewise subscribed by the same persons.

These documents, with certain others into which it is here unnecessary to go, are delivered to the Registrar of Companies in the Companies' Registration Department of the Board of Trade, the requisite fees and duties are paid, and the Registrar issues a Certificate of Incorporation.

The company then becomes a composite "person," capable of holding land, of suing and being sued, and having a common seal wherewith to signify its assent to important documents. It is a person distinct from its members; a fact which must be borne in mind carefully.

The capital stated in the Memorandum is that upon which stamp duty is payable. This capital may be altered in various ways as will be seen later. On any increase, additional duty is payable.

Whether or not the whole of this capital is "issued," i.e. taken up by members, depends upon the requirements of the company. The capital is divided into "shares" of whatever nominal amount the company requires or deems expedient. Persons who apply for these shares may be refused allotment; those to whom shares are allotted become members.

The great feature of limited liability is the fact that a person who takes up a share knows that once he has paid for it in full, he cannot be called upon to contribute more to the company, even to pay its debts. And so long as his shares are partly paid, he knows the full extent of his liability is limited to the amount unpaid on his shares whatever may happen, unless he agrees in writing to contribute more.

A person who gives credit to a company, knowing of the limitation on the members' liability, does so on the strength of the assets of the company. If the members were allowed to dissipate such assets by repaying their own capital, the creditors might be seriously prejudiced. It is therefore a rule of company law that capital shall not be capable of being repaid except in three circumstances, viz. on an authorized reduction, on a redemption of redeemable preference shares, or on winding up the company by the legal formalities, and in each case the rights of creditors are safeguarded.

It is this insistence upon the maintenance of capital that is the dominant feature of company accounting. Double-entry book-keeping principles are applied throughout; that is a fundamental requirement if records are to be complete. The greatest care must, however, be taken in applying such principles, to distinguish capital from revenue, and to ensure that capital is maintained.

This work is not a treatise upon Company Law. Readers are presumed to have some knowledge thereof, and the law is mentioned herein only in so far as it directly affects the accounts.

CHAPTER II

THE ADVANTAGES OF LIMITED COMPANIES

In this chapter a brief summary of the advantages of a limited company, from the viewpoint of its members, over a partnership or sole trader's concern are discussed, as these advantages help to fix in the mind the nature of a company. Readers must bear firmly in mind the fact that a company is a legal entity distinct from its members, whereas a partnership is not. The company contracts in its own right, it can sue and be sued in its own right. Any member can contract with the company, even if that member holds practically the whole of the shares in it. Where a director is interested in a contract made with the company, however, there may be a restriction imposed by the company's regulations thereon, and by Section 149 of the Companies Act, 1929, a director who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company must declare the nature of his interest at a meeting of the directors, either when the contract is first considered, or at the first meeting after he becomes interested in the contract, if this is later. A general notice to the effect that he is a member of a specified company or firm, and is to be regarded as interested in any contract made therewith, is sufficient.

Unless empowered by the Articles, a director may not vote on any contract in which he is interested, and cannot be included in a quorum

considering it. At a general meeting, however, he can so vote and be included in a quorum. It is only as a director that he is restricted; as a member he can contract and be interested in contracts with the company. Moreover, the Articles commonly give power to vote as a director in such circumstances.

The advantage of a company which is most apparent is that of limited liability. Each member is liable to pay the nominal value of the shares that he agrees to take up, and cannot be called upon to pay more, save in the case of a guarantee company, where he may, in winding up, be called upon to contribute not more than the sum stated in the Memorandum if required to pay the company's debts. This guarantee, however, is also limited.

If shares are issued at a discount under Section 47 of the Act (as to which see Chapter III), the amount for which the member is liable is reduced by the amount of the discount.

A member of a partnership (save only the limited partners duly registered in a limited partnership), or a sole trader on the other hand, is liable to the full extent of his property for all the business debts. In the case of a partnership this may be serious, particularly if the other partners are unable to contribute their due proportion.

The company, again, is the only means of banding together large numbers of persons to carry on business in common with a view of profit. The number of persons who can be partners in a business whose object is the acquisition of gain, is twenty, except in the case of banking, where it is

ten. In a public company, however, the only limit to the number of shareholders is the number of shares authorized, which can always be increased; there is, however, a minimum of seven members. In a private company, the minimum is two, and the maximum fifty (excluding members who are employees or who took up their shares while employees and have continued to hold them ever since).

In a partnership, each member (other than a limited partner) can take part in the management and bind the firm in relations with others, whereas in a company the management is delegated to directors or managers.

Every partner has a right to inspect and take copies of the books and accounts, subject to any contrary agreement. Subject to the Articles, a member of a company has no such right, except in respect of certain statistical books mentioned by Statute (as to which see Chapter VIII).

A partnership or sole trader can alter the nature of the business at will, and the rights of partners among themselves are governed only by the agreement, which can also be varied at will. A company, on the contrary, cannot carry on any business not authorized by the Memorandum, which can only be varied to a limited extent and then only by the methods laid down in the Act, which involve application to the Court. The rights of members and directors are governed by the Articles, which can only be altered by Special Resolution in general meeting of the company. The contents of a partnership agreement are private, and cannot bind outsiders; the contents of a company's Memorandum and Articles are public, since anyone can

inspect them at the office of the Registrar of Companies, and the public are presumed to know their contents.

The Partnership Act, 1890, governs partnerships, but, in general, only where their agreement does not provide otherwise. The Companies Act, 1929, governs companies, and cannot be varied by the company.

The capital of a partnership is variable as may be agreed upon; that of a company can only be varied as provided by the Act (as to which see Chapter VI).

The profits of a partnership can be withdrawn at will; those of a company can only be paid out as dividends passed by a general meeting unless the Articles empower the directors to declare dividends.

The books of account to be kept by a firm depend entirely upon their agreement; the only compulsion being the practical one that the Commissioners of Inland Revenue may be able to force accounts to be produced, or that it may be an offence in the event of bankruptcy that books have not been kept. A company, on the contrary, must keep proper books, under penalties for default (see Chapter VIII). A company must have its annual balance sheet audited; partnerships and sole traders have no such compulsion on them.

On the death of a partner, there is an interruption in the business. The firm, unless the agreement provides otherwise, is dissolved, and there is usually difficulty in valuing the share of the deceased, for which provision has to be made. The death of a member of a company does not

disturb its entity. His share passes to his successor as property, and the successor becomes a member in his place.

Where further capital has to be raised at any time, it may be difficult for a sole trader or firm to obtain it without bringing in another partner, and the lender may not desire to assume the responsibility and liabilities of partnership. A charge can only be given by Bill of Sale, which would ruin the credit of the business. In a company, further shares can be issued, giving, if required, preferential rights, or debentures, giving a fixed or floating charge, can be issued.

Control can still be left with the original members, since new shares can be issued with restricted or no voting rights.

Where a parent wishes to make some provision for his family, and to bring sons or daughters into the business, the company offers peculiar advantages over partnership. In the case of a company, he can generally make over shares to them, in whatever proportions he desires, whilst retaining control. He can also gradually relieve himself of the management, but retain control in case he deems it necessary to intervene. Shares can similarly be given to employees where desired.

The taxation benefits and disadvantages hardly come within the scope of this work, and are therefore not dealt with here.

The chief disadvantages can be summarized in a few words. Statutory and constitutional restrictions as to meetings, returns, etc., are not really serious. The initial stamp duties and fees are the

chief burden, the price paid for the greater safeguards and the flexibility obtained. In small concerns, credit may be affected, but this is rarely the case unless the management is suspected of being incapable.

CHAPTER III

SHARE CAPITAL

CLASSES of shares—Prospectus—Issue of shares—Underwriting—Brokerage—Forfeiture—Lien—Return of allotments

CLASSES OF SHARES AND CAPITAL

THE share capital of a company can be, and frequently is, divided into several classes, e.g. preference, ordinary, deferred. The rights attaching to each class are set out in the Memorandum and/or Articles of Association.

Preference shares are those to which some preferential rights are given, e.g. as to dividend, return of capital, or both. Such shares are cumulative (i.e. the dividends must be paid right up to date before inferior classes receive any dividends) unless the terms of issue provide otherwise.

Ordinary shares are those entitled to what remains after the preference shareholders have been satisfied, but subject to any rights of deferred shareholders.

Deferred shares rank after ordinary shares, but where such shares exist, the holders are frequently given the right to receive the whole or a considerable portion of the profits remaining after the ordinary shares have received a maximum dividend, and are thus very valuable in a prosperous concern.

Founders' shares are, as their name implies, shares issued to promoters, vendors, etc., and are usually deferred shares.

Each class may be further subdivided, according to the desires of the promoters or members.

The following are terms frequently met in company accounting in connexion with share capital—

Nominal or Authorized Capital. The amount of capital registered at the office of the Registrar of Companies as the capital of the company. Any increase or reduction of capital changes the nominal amount, but otherwise it remains constant.

Issued or Subscribed Capital. The amount of capital actually issued, either for subscription or in settlement of consideration for the acquisition of assets.

Called-up Capital. That part of the subscribed capital which has been called up.

Paid-up Capital. The proportion of capital paid for in full either in money or money's worth.

Uncalled Capital. The proportion of capital issued on which calls have not yet been made.

Unissued Capital. The proportion of the authorized capital not yet issued.

In the case of a private company, the capital must be issued privately, and in the case of many public companies, also, private arrangements are made. The book-keeping involved in such cases is usually simple, as the cash is subscribed as and when required. If, in a private issue, more formal steps are taken, the amounts will be similar to those involved in a public issue.

Application and Allotment. Where it is desired to raise money by public subscription, a prospectus, containing the information required by the Companies Act, 1929, will be issued, inviting the public to subscribe for shares on the terms therein set out. A stated sum per share must be paid on application, a further sum will be payable on

APPLICATION AND ALLOTMENT SHEET

Serial No.	Name	Address	Description	No. of Shares Applied for	Date	C.B. Fo.	Amount Paid			No. of Shares Allotted	Distinctive Numbers		Amount Due on Application and Allotment			Balance Due on Allotment			Date Paid	C B. Fo	Amount Paid			Amount Returned (Date)			C B Fo.	Folio in New Register of Members
							£	s	d.		From	To	£	s	d	£	s	d.			£	s	d	£	s	d		

allotment, and the balance will be "called" as and when the company requires it.

On receipt of applications, the company will list them on Application and Allotment sheets ruled in a manner somewhat similar to that shown opposite.

In the financial books, entries for dealings in share capital are dealt with in totals, not in individual amounts. On receipt of the application moneys, an Application and Allotment Account will be credited, but no entry should be made in the Share Capital Account, as at this date there is no contract with the applicant. The latter can withdraw his application at any time before allotment. Immediately shares have been allotted and the allotment letters posted (these being the official acceptance of the offer) there is a binding contract between the applicant and the company, and Share Capital Account can be credited, Application and Allotment Account being debited, with the amount due on Application and Allotment. When the cash is received, it is credited to the latter account. Usually a separate banking account will be opened, to facilitate checking. This special account will be closed in due course by transfer to the General Cash Account.

When a call is made, Call Sheets will be prepared. If the call is to follow shortly after the allotment, additional columns on the Application and Allotment Sheets can be provided for the purpose.

Where the issue is not over-subscribed, there is no difficulty involved in recording the details, as will be seen from the following illustration.

Illustration. *A prospectus invited applications for* 50,000 *shares of* £1 *each, payable as to* 1s. *per share on application,* 2s. *per share on allotment, and* 7s. *a share on first call. The issue was fully subscribed. Record the transactions, ledger accounts only.*

SHARE CAPITAL ACCOUNT

					£
			By Application and Allotment Account, 3s per share	(2)	7,500
			" First Call Account, 7s per share	(4)	17,500

APPLICATION AND ALLOTMENT ACCOUNT

		£			£
To Share Capital Account	(2)	7,500	By Cash, 1s. per share on application	(1)	2,500
			" Cash, 2s. a share on allotment	(3)	5,000
		£7,500			£7,500

1ST CALL ACCOUNT

		£			£
To Share Capital Account	(4)	17,500	By Cash	(5)	17,500

The order of the entries is shown by the figures in brackets.

An under-subscription is recorded in precisely the same manner. Where, however, the amount applied for is so small that the directors cannot go to allotment, e.g. where the minimum subscription is not reached, it is necessary to return the money subscribed.

Illustration. *A prospectus was issued inviting subscriptions for* 80,000 £1 *shares, and stating that the minimum subscription upon which the directors would proceed to allotment was* 45,000 *shares. Applications were received for* 40,000 *shares only, and the money was returned in due course. Record*

the transaction, assuming that 2s. 6*d. per share was payable on application.*

APPLICATION AND ALLOTMENT ACCOUNT

		£			£
To Cash, on return of applications	(2)	5000	By Cash, application for 40,000 shares . .	(1)	5000

OVER-SUBSCRIPTION

Where the issue is over-subscribed, the directors must decide upon the basis of allotment. If the over-subscription is small, allotment is usually made *pro rata*, the money over-paid on application being carried forward towards the amount due on allotment (and on calls, if it exceeds the amount due on allotment).

Illustration. *A prospectus invited applications for* 140,000 10*s. shares, payable* 1*s. on application,* 2*s. on allotment,* 2*s. on first call, and* 5*s. on second call. Applications were received for* 200,000 *shares, and pro rata allotment was made. Record the transactions, assuming all sums due were duly received.*

SHARE CAPITAL ACCOUNT

		£			£
To Balance c/d		70,000	By Application and Allotment Account . .	(2)	21,000
			„ First Call Account .	(4)	14,000
			„ Second Call Account	(6)	35,000
		£70,000			£70,000
			By Balance b/d . . .		70,000

APPLICATION AND ALLOTMENT ACCOUNT

		£			£
To Share Capital Account, Allotment of 140,000 shares . . .	(2)	21,000	By Cash, Applications for 200,000 shares . .	(1)	10,000
			„ Cash, Balance due .	(3)	11,000
		£21,000			£21,000

1st CALL ACCOUNT

		£			£
To Share Capital Account	(4)	14,000	By Cash	(5)	14,000

2nd CALL ACCOUNT

		£			£
To Share Capital Account .	(6)	35,000	By Cash . .	(7)	35,000

A very heavy over-subscription may make a *pro rata* allotment impracticable, or undesirable. In such cases, a return of the application money is essential. The basis upon which allotment is made varies considerably. The issue will be "closed" at a certain time, and all applications received thereafter (except "country" applications which came in by a later post, but postmarked before that time) will be returned. Of those received within the stated time limit, a choice will be made.

Where, as in the case of a "big store," every member is a potential customer, as many members as possible will be wanted, and it is usual to allot to applicants for small numbers in full, and to grade the allotments so that the applicants for the largest numbers of shares are allotted a proportionally smaller number.

✓**Illustration.** *In an issue of* 160,000 *shares, applications were received for* 250,000. *Of these,* 80,000 *were in lots of* 200 *or less,* 120,000 *for lots exceeding* 200, *but not exceeding* 500, 40,000 *for lots exceeding* 500, *but not exceeding* 1000, *and the balance in lots exceeding* 1000.

Allotment was made as follows—

Applicants for 200 shares or less, in full		80,000 shares
Over 200, but not exceeding 500 shares,	55%	66,000 ,,
,, 500, ,, ,, 1000 ,,	30%	12,000 ,,
,, 1000	20%	2,000 ,,
		160,000

In many cases, however, the constitution of the membership does not matter, and in order to reduce the immediate clerical labour in entering up the Register of Members, preparation of call lists, letters, etc., the allotment is made in full to applicants for the largest numbers of shares and small applications eliminated.

Illustration. *Taking the same figures of applications as in the previous example,*

Allotment is made as follows—

To applicants for over 500 shares, in full . . .	50,000
200, but not exceeding 500, 11 shares for each 12 applied for	110,000
	160,000

Some other selective basis may be decided upon on the facts of the case. Enough should have been said above to indicate the treatment in the books, and we conclude this topic by the following statement of the actual basis of allotment in a recent issue of 534,000 ordinary shares.

Applications for—	*Received*
1 to 49 shares . . .	0
50 ,, 100 ,, . . .	50
101 ,, 200 ,, . . .	100
201 ,, 550 ,, . . .	150
551 ,, 900 ,, . . .	250
901 ,, 1400 ,, . . .	350
1,401 ,, 1800 ,, . . .	400
1,801 ,, 2500 ,, . . .	450
3,000 ,, . . .	500
4,000 ,, . . .	550
5,000 ,, . . .	600
6,000 ,, . . .	700
7,000 ,, . . .	800
8,000 ,, . . .	900
9,000 ,, . . .	1,000
10,000 ,, . . .	2,000

SHARES AT A PREMIUM

Shares may be issued at a premium, if they will command it in the market. The premium is usually collected with the allotment money, the entry being to debit Application and Allotment Account and credit Premium on Shares Account therewith.

Illustration. *A prospectus invited applications for* 200,000 *shares of* 2s. *each, at a premium of* 6d. *a share, payable as to* 6d. *on application,* 1s. *on allotment (including the premium) and the balance one month later. All sums were paid when due and applications were received for* 180,000 *shares.*

SHARE CAPITAL ACCOUNT

		£			£
To Balance c/d . .		18,000	By Application and Allotment Account . .	(2)	9,000
			„ Call Account .	(5)	9,000
		£18,000			£18,000
			By Balance b/d .		18,000

APPLICATION AND ALLOTMENT ACCOUNT

		£			£
To Share Capital Account .	(2)	9,000	By Cash, Applications	(1)	4,500
„ Premium on Shares Account . . .	(3)	4,500	„ Cash, Allotment . .	(4)	9,000
		£13,500			£13,500

PREMIUM ON SHARES ACCOUNT

					£
			By Application and Allotment Account . .	(3)	4,500

CALL ACCOUNT

		£			£
To Share Capital Account .	(5)	9,000	By Cash	(6)	9,000

SHARES AT A DISCOUNT

Shares cannot be issued at a discount in any circumstances except the very circumscribed ones provided by Section 47 of the Companies Act, 1929, viz.—

(1) The shares must be of a class already issued.

(2) The issue must be authorized by a resolution passed in general meeting of the company, and must be sanctioned by the Court.

(3) The resolution must specify the maximum rate of discount at which the shares are to be issued.

(4) Not less than one year must at the date of the issue have elapsed since the date on which the company was entitled to commence business.

(5) The shares to be issued at a discount must be issued within one month after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow.

The Court may sanction the issue on such terms and conditions as it thinks fit. Every prospectus and Balance Sheet subsequently issued must show particulars of the discount allowed, in so far as it has not been written off.

If shares are issued at a discount in any other circumstances, the holders of such shares are liable to pay for them in full.

The purpose of Section 47 is to permit companies whose shares are worth less than par, to raise capital by issuing shares at their market value, when it would be impossible to do so at par.

Illustration. *The following is the summarized Balance Sheet of a company—*

	£		£
Share Capital, £1 shares fully paid . . .	140,000	Sundry Assets . .	239,000
Creditors . . .	121,000	Profit and Loss Account	22,000
	£261,000		£261,000

The shares stand at 19s. each in the market, and it is desired to raise further capital. Obviously when existing £1 shares can be acquired in the market for 19s. each, it is impossible to obtain subscriptions for new shares at £1 each. Provided, however, that the reasons for the issue are sound, it is probable that an issue at 19s. per £1 share would succeed.

Such an issue follows the usual procedure. The amount of the discount is debited to Discount on Shares Account and credited to Share Capital Account. Provision should be made to write off the discount over a short period of years. The balance of the discount account must appear separately from other items in the Balance Sheet.

UNDERWRITING

Before issuing a prospectus in respect of an issue of shares, it is usual to ensure that the issue will be taken up, whatever happens, by means of "underwriting." Persons are found who, in return for a commission upon the number of shares underwritten, will engage to take up any shares which are not taken by the public. A contract is entered into whereby the underwriters apply for the specified number of shares underwritten, but are to be relieved *pro rata* in respect of the shares actually taken up by the public. In some cases a further commission is paid to the main underwriters for placing underwriting with others, called "sub-underwriters"; this commission is called "overriding" commission.

Illustration. *A company which was about to make an issue of* 50,000 £1 *shares, entered into an*

underwriting agreement with The X Syndicate, whereby the latter agreed to place the whole of the underwriting, the commission to be 4 *per cent with an overriding* 1 *per cent. X Syndicate placed* 20,000 *with A,* 10,000 *with B, and* 5,000 *with C.*

The public applied for 30,000 *shares. Apportion the shares among the underwriters and show the commission payable.*

APPORTIONMENT OF 20,000 SHARES NOT TAKEN BY PUBLIC

		Shares	*Commission*		
A . .	$\frac{20,000}{50,000}$ of 20,000 =	8,000	4% on £20,000	=	£800
B . .	$\frac{10,000}{50,000}$ of 20,000 =	4,000	4% on £10,000	=	400
C . .	$\frac{5,000}{50,000}$ of 20,000 =	2,000	4% on £5,000	=	200
X Syndicate	$\frac{15,000}{50,000}$ of 20,000 =	6,000	4% on £15,000 1% on £50,000	=	1,100
		20,000			£2,500

In some cases, the underwriters take up some of the issue "firm," i.e. their applications for the shares so taken are to receive allotments, no matter what may be the result of the issue. These firm applications may be contracted to relieve the underwriter to that extent from his underwriting liability. In other cases, applications from the public on forms bearing the stamp of the underwriter go to his relief. The agreements in such cases must be very carefully drawn up, so as to leave no doubt as to the method of apportioning the ultimate balance (if any) not taken by the public; in particular as to how excesses of one underwriter are to be set off against deficiencies of another.

Illustration. *An issue of* 80,000 £1 *shares was underwritten at a commission of* 4 *per cent. The*

underwriting was taken up by A, 40 per cent; B, 25 per cent; C, 20 per cent; and D, 15 per cent; applications bearing the stamp of an underwriter to be applied in relief of his liability, any excesses to be ignored. Subscriptions were received as follows—

	Shares
Unstamped applications . . .	10,000
Applications bearing the stamp of—	
A	20,000
B	10,000
C	5,000
D	25,000
	70,000

Show the allocation of the shares among the underwriters.

The underwriters are left with 10,000 shares, allocated as follows—

	A	B	C	D
Amount underwritten . .	32,000	20,000	16,000	12,000
Deduct Marked Applications .	20,000	10,000	5,000	25,000
Net liability . . .	12,000	10,000	11,000	*nil*

Allocation of shares not taken by public: $\frac{12}{33}$ of 10,000 = 3637, $\frac{10}{33}$ of 10,000 = 3030; $\frac{11}{33}$ of 10,000 = 3333; —.

Note. It would be provided that the nearest whole number of shares be taken.

Alternatively, the agreement may provide that excesses be taken into account, in which case the allocation will be as follows—

Allocate all shares not taken by the public direct, i.e. 80,000 − 10,000 = 70,000.

	A	B	C	D
	40% 28,000	25% 17,500	20% 14,000	15% 10,500
Deduct Marked Applications .	20,000	10,000	5,000	25,000
Deficiency .	8,000	7,500	9,000	Surplus 14,500
Deduct D's surplus, in ratio 40, 25, 20	6,823	4,265	3,412	
Final allocation .	1,177	3 235	5,588	

Underwriting commission may be payable either in cash or in shares, or partly in cash and partly in shares. Regard must be had to the provisions of the Companies Act, 1929, as regards shares.

(1) (*a*) the payment must be authorized by the Articles of Association;

(*b*) the commission must not exceed 10 per cent of the issue price or the amount or rate authorized by the Articles, whichever is the less;

(*c*) the amount or rate per cent of the commission must, in the case of an issue to the public, be disclosed in the prospectus, and in the case of shares not offered to the public, in the statement in lieu of prospectus, or in a statement in the prescribed form signed in a like manner as a statement in lieu of prospectus and filed with the Registrar of Companies, and where a circular or notice, not being a prospectus, invites subscriptions for the shares, the notice must disclose the amount or rate of commission;

(*d*) the number of shares which persons have agreed for a commission to subscribe absolutely must be similarly disclosed.

(2) Save as above, no company may apply any of its capital in paying any commission for taking up shares.

(3) Brokerage can still be paid in the usual way, despite the above.

(4) A vendor to, promoter of, or other person who receives payment in money or shares from, a company, can apply part thereof in paying commission which would have been legal if paid by the company. (S. 43.)

Any commission in respect of shares or debentures must, so far as it has not been written off, be stated in every Balance Sheet of the company until wholly written off. (S. 44.)

The underwriting agreement usually stipulates that the commission shall not be payable until the amount due on allotment has been paid by the underwriters on the shares which they have had to take up.

A further and more complicated example of apportionment of shares among underwriters whose firm or marked applications go to their relief will now be given. In this example a further method of apportionment is disclosed.

Illustration. *An issue of* 100,000 £1 *shares was fully underwritten as shown hereunder. Firm and marked applications were to go in relief of the underwriters, and the agreement proposed that those underwriters whose firm and marked applications exceeded their gross underwriting liability be ignored, the remaining underwriters being "saddled" with the fair percentage of the shares not taken up by the public. Unmarked applications were received for* 22,000 *shares.*

	No. of Shares Underwritten	*Firm Applications*	*Marked Applications*	*Percentage of Firm and Marked Applications to Amount Underwritten*
A	5,000	2,000	1,000	60
B	15,000	4,000	2,000	40
C	20,000	4,000	—	20
D	5,000	—	1,000	20
E	1,000	—	—	—
F	2,000	1,000	—	50
G	8,000	2,000	1,000	37·5
H	30,000	5,000	—	16·66
K	14,000	6,000	6,000	85·71
	100,000	24,000	11,000	

Total Issue	100,000
Deduct Unmarked Applications	22,000
To be taken by underwriters or marked forms	78,000 or 78%

Since K has applied or obtained application for over 78 per cent of his underwriting, he will not be called upon to take up any of the deficiency. Deducting the applications for which he is responsible, there remain 66,000 shares to be taken up

by the remaining underwriters, who have underwritten 86,000 shares. The percentage to be taken by each is thus $\frac{66,000 \times 100}{86,000} = 76{\cdot}7442$ per cent.

APPORTIONMENT

	76·7442% of Shares Underwritten	Deduct Firm and Marked Applications	Share of Deficiency
A	3,837	3,000	837
B	11,512	6,000	5,512
C	15,349	4,000	11,349
D	3,837	1,000	2,837
E	767	—	767
F	1,535	1,000	535
G	6,140	3,000	3,140
H	23,023	5,000	18,023
	66,000	23,000	43,000

Summary—

Shares taken by public on unmarked forms	22,000
Shares taken by public on marked forms	11,000
A	2,837
B	9,512
C	15,349
D	2,837
E	767
F	1,535
G	5,140
H	23,023
K	6,000
	100,000

Brokerage is a commission paid to brokers for procuring subscriptions for shares. In large public issues, it is usual to provide that brokerage will be paid on all applications bearing the stamp of a recognized firm of stockbrokers.

There is nothing to prevent the payment of any commission for underwriting or brokerage out of profits; the provisions of the Companies Act set

out *ante* are designed to deal with payments of commission out of capital.

REMEDIES FOR UNPAID CALLS

In the normal course of events, it is sometimes found that a person who has taken up shares in a company is unable or unwilling to pay up the balances as they become due. It is then necessary to decide what steps shall be taken to collect the amounts due.

The company can always sue for the money, but this would often mean throwing good money after bad, and it is not a popular method, except in those cases where the shares when paid up will be worth less than the amount now payable on them. For example, if on a £1 share, 12s. 6d. paid, the balance of 7s. 6d. is called, but the fully paid share will be worth only 7s. or less, it would obviously be more beneficial to the holder to get rid of the share if he could without paying the call. The company's only practicable method is to sue for the balance. If, however, the share will be worth more than 7s. 6d., the company would find it more profitable to forfeit the share.

Forfeiture is a serious step, whereby the company, by a resolution of the directors, expropriates the holder of the share, whereupon he ceases to be a member (although liable to be placed upon the B list of contributories in the event of the company going into liquidation within a year).

The procedure for forfeiting shares usually follows that laid down in Table A, which is as follows—

(1) Where a member fails to pay any call or instalment on the day appointed for payment, the directors may, at any

time before the whole amount due has been received, serve a notice upon him requiring him to pay the unpaid amount, together with any interest that may have accrued.

(2) The notice must name a day, not less than fourteen days from the date of the notice, on or before which the payment required by the notice is to be made, and must state that in the event of non-payment at or before the time appointed, the shares will be liable to be forfeited.

(3) If the requirements of the notice are not complied with, any shares in respect of which the notice was given may at any time thereafter, before the payment required by the notice has been made, be forfeited by resolution of the directors to that effect.

(4) A forfeited share may be sold or otherwise disposed of on such terms and in such manner as the directors think fit, and at any time before a sale or disposition the forfeiture may be cancelled on such terms as the directors think fit.

(5) A person whose shares have been forfeited shall cease to be a member in respect of the forfeited shares, but remains liable to pay to the company all moneys due at the date of forfeiture, but his liability ceases if and when the company receives payment in full of the nominal value of the shares.

(6) A statutory declaration in writing by a director as to the forfeiture is conclusive evidence of the facts against all persons claiming to be entitled to the shares, and the company can execute a transfer in favour of the person to whom the shares may be re-sold.

It cannot be too strongly emphasized that a company cannot forfeit shares unless so empowered by its Articles, and that the method laid down in the Articles must then be followed strictly, otherwise the forfeiture will be irregular and liable to be set aside if the member who has been expropriated takes the matter to the Court.

Immediately the resolution for forfeiture has been properly passed, the necessary entries must be made in the books to eliminate the balances in respect of the shares from all accounts in which they appear, and to open a Forfeited Shares

Account, which will be credited with the amount paid on the shares by the defaulting holder.

Example. *A company made an issue of* 60,000 £1 *shares, which was fully subscribed. The sum of* 7s. 6*d. had been paid on application and allotment. The first call of* 2s. 6*d. and the second call of* 5s. *had been received with the exception of the amounts due on* 100 *shares held by M. These shares were duly forfeited.*

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		£	s.	d.	£	s.	d.
	Share Capital Account . *Dr.*	75	0	0			
	To Forfeited Shares Account				75	0	0
	Amount credited to date on 100 shares forfeited per minute of this day						
	Forfeited Shares Account . *Dr*	37	10	0			
	To First Call Account . .				12	10	0
	,, Second Call Account .				25	0	0
	Calls due on shares forfeited.						

The net balance on forfeited Shares Account is now £37 10s., the sum paid by M on application and allotment.

The shares should also be transferred to a Forfeited Shares Account in the Register of Members.

The effect of forfeiture is to reduce the issued share capital to the extent of the shares in question, and the balance on the Forfeited Shares Account should be shown specifically in the Balance Sheet until the shares are reissued.

On reissue, the person who acquires the shares is debited with the price he is paying for them (which must not be such as will result in the company getting less than the nominal value from the old and new holders together, but is usually such

as to give a profit to the company). Any difference between the price and the amount credited as paid will be debited to the Forfeited Shares Account, since part of the moneys paid by the former holder is being used to pay up the shares in the hands of the new holder. The balance remaining in Forfeited Shares Account in respect of the reissued shares is then a profit, which should be taken to Premium on Shares Account (if any) or to Premium on Forfeited Shares Reissued Account or Reserve. Apparently it would not be illegal to include such a profit in the profits available for dividend, but it is in essence a capital profit best used for capital purposes.

Illustration. *The shares forfeited in the previous example were reissued to* P, *credited as* 15*s. paid, for* 12*s. a share.*

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		£	s.	d.	£	s.	d.
	P . . . . . . *Dr.*	60	0	0			
	Forfeited Shares Account . *Dr.*	15	0	0			
	To Share Capital Account .				75	0	0
	Reissue of 100 shares credited 15s. paid for 12s. each, per minute of this day.						
	Forfeited Shares Account . *Dr.*	22	10	0			
	To Premium on Forfeited Shares Reissued Account .				22	10	0
	Profit on reissue transferred.						

Where shares issued at a premium are forfeited, it must be remembered that the premium is not strictly part of the money paid *on* the share itself, but rather a sum paid for the right to be allowed to take up the share. Hence, if the premium has

been received, it is not necessary to disturb the Premium Account. If, however, the premium has not been received, it should be written back to the Account, whether Allotment or Call Account, to which it was originally charged, and not taken to Forfeited Shares Account.

LIEN

An alternative to forfeiture is the exercise of lien, which may be termed the right to hold the property of another as security for the performance of an obligation. The company has a lien over shares only if the Articles of Association expressly provide for it. Table A provides for a lien in every share (not being a fully-paid share) for all moneys called or payable at a fixed time in respect of that share, and also for a lien on all shares (not being fully paid shares) standing registered in the name of a single person for all moneys presently payable by him or his estate to the company. The lien extends to all dividends.

The company may sell, in such manner as the directors think fit, any shares on which the company has a lien, but not unless some sum in respect of which the lien exists is presently payable, nor until the expiration of fourteen days after a notice in writing, stating and demanding payment of such part of the amount in respect of which the lien exists as is presently payable, has been given to the registered holder or the person entitled by reason of his death or bankruptcy.

For giving effect to any such sale the directors may authorize some person to transfer the shares to the purchaser, whose title is protected.

Any excess sum realized on the sale of the shares over what is due must be paid to the person entitled to the shares at the date of sale.

Articles of Association frequently modify Table A in this respect to extend the lien for other debts to fully-paid shares. Where a Stock Exchange quotation is desired, however, this extension must be omitted.

It will be seen that the company has precisely as much trouble with the enforcement of lien as it has with forfeiture. In the latter case, however, it retains any profit on reissue, whereas it must account for any profit on sale in the case of lien. Forfeiture is therefore more popular, lien being relied upon chiefly for sums due other than calls.

The entries in the books on the enforcement of lien are simple.

Illustration. *A owed to a company £20 for goods and £25 for a call on 100 shares, credited with 15s. paid. The company enforced the lien, selling 80 of the shares, credited as 15s. paid, for 12s. each.*

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		£	s.	d.	£	s.	d.
	Cash . . . . . *Dr.*	48	0	0			
	To A, Personal Account .				20	0	0
	(Amount due for goods.)						
	,, Call Account . . .				25	0	0
	(Amount due on 100 shares.)						
	,, A				3	0	0
	(Profit on sale.)						
	Sale of 80 shares, credited 15s. paid, for 12s. each, in exercise of lien per minute of this day.						
	A . . . . *Dr.*	3	0	0			
	To Cash				3	0	0
	Profit accounted for.						

Under Table A the lien for moneys other than those due on shares extends only to shares registered in the name of a single person; trusts therefore commonly register their holdings in the names of two or more persons.

A comprehensive example of the issue and forfeiture of shares will now be given.

Illustration. *X Ltd. issued a prospectus inviting applications for* 120,000 *Ordinary Shares of* £1 *each, payable as to* 2*s. per share on application and* 3*s.* 6*d. on allotment (including a premium of* 6*d. per share).*

The public applied for 200,000 *shares on* 1*st May. The directors returned the applications for* 40,000 *shares, and allotted* pro rata *to the remaining applicants. Allotment letters were posted on* 3*rd May.*

A, who had been allotted 240 *shares, failed to pay the allotment money, the balance of which was paid on* 10*th May.*

The directors called up 5*s. per share on* 3*rd June, and the call money was received on* 10*th June, with the exception of that due from A and from B, the holder of* 300 *shares.*

A second call of 2*s.* 6*d. per share was made on* 4*th July, and the money paid on* 10*th July. C failed to pay the call on* 200 *shares. B also defaulted. On* 29*th June, A's shares were forfeited, and on* 30*th July, B's shares were also forfeited.*

On 15*th August, the directors reissued to D the shares formerly held by A, credited as* 12*s.* 6*d. paid, for* 11*s., and to F* 100 *of the shares formerly held by B, at a similar price.*

Write up the Journal, Cash Book, and Ledger in respect of the above transactions.

JOURNAL

Date	Particulars	£	s.	d.	£	s.	d.
19.. May 3	Application and Allotment Account . . . . *Dr.*	33,000	0	0			
	To Ordinary Share Capital Account . . .				30,000	0	0
	,, Premium on Shares Account . . .				3,000	0	0
	Amount due on application and allotment on 120,000 shares allotted per minute this day.						
June 3	First Call Account . . *Dr.*	30,000	0	0			
	To Ordinary Share Capital Account . . .				30,000	0	0
	Call of 5s. per share on 120,000 shares, per minute of this day.						
29	Ordinary Share Capital Account . . . . *Dr.*	120	0	0			
	To Forfeited Shares Account				120	0	0
	Forfeiture per minute of this day of 240 shares held by A, for non-payment of allotment money and first call.						
✓	Forfeited Shares Account . *Dr.*	88	0	0			
	To Application and Allotment Account . .				28	0	0
	,, First Call Account . .				60	0	0
	Transfer of amounts unpaid on A's shares forfeited.						
	Premium on Shares Account *Dr.*	6	0	0			
	To Application and Allotment Account . .				6	0	0
	Unpaid premium written back *re* shares forfeited.						
July 4	Second Call Account. . *Dr.*	14,970	0	0			
	To Ordinary Share Capital Account . . .				14,970	0	0
	Call of 2s. 6d. per share on 119,760 shares, per minute of this day.						
30	Ordinary Share Capital Account . . . . *Dr.*	187	10	0			
	To Forfeited Shares Account				187	10	0
	Forfeiture per minute of this day of 300 shares held by B, for non-payment of first and second calls.						

JOURNAL—(*contd.*)

		£	s.	d.	£	s.	d.
19.. July 30	Forfeited Shares Account . *Dr.*	112	10	0			
	To First Call Account . .				75	0	0
	,, Second Call Account .				37	10	0
	Transfer of amounts unpaid on B's shares forfeited.						
Aug. 15	Sundries . . . . *Dr.*						
	To Ordinary Share Capital Account . . .				212	10	0
	D	132	0	0			
	F	55	0	0			
	Forfeited Shares Account . .	25	10	0			
	Reissue of 340 ordinary shares, credited as 12s. 6d. paid, for 11s. each.						
	Forfeited Shares Account . *Dr.*	31	10	0			
	To Premium on Shares Account . . .				31	10	0
	Profit on reissue of 340 shares.						

CASH BOOK

19..		£	s.	d.	19..		£	s.	d.
May 1	To Applications for 200,000 shares, 2s. per share	20,000	0	0	May 3	By Returned Applications for 40,000 shares, 2s. per share .	4,000	0	0
10	,, Allotment money: 3s. 6d. per share on 119,760 shares . 20,958 *Less* overpaid on application, 2s. per share on 39,920 shares . 3,992	16,966	0	0					
June 10	,, First Call—5s. per share on 119,460 shares . .	29,865	0	0					
July 10	,, Second Call—2s. 6d. per share on 119,260 shares	14,907	10	0					
Aug. 15	,, D, 11s. per share on 240 shares .	132	0	0					
	,, F, 11s. per share on 100 shares .	55	0	0					

LEDGER

Ordinary Share Capital Account

Date		£	s.	d.	Date		£	s.	d.
19..					19..				
June 29	To Forfeited Shares Account . .	120	0	0	May 3	By Application and Allotment Account . .	30,000	0	0
July 30	" Forfeited Shares Account .	187	10	0	June 3	" First Call Acct. .	30,000	0	0
					July 4	" Second Call Acct.	14,970	0	0
					Aug. 15	" Sundries .	212	10	0

Premium on Shares Account

Date		£	s.	d.	Date		£	s.	d.
19..					19				
June 29	To Application and Allotment Acct..	6	0	0	May 3	By Application and Allotment Acct.	3000	0	0
					Aug. 15	" Forfeited Shares Account	31	10	0

Application and Allotment Account

Date		£	s.	d.	Date		£	s.	d.
19..					19..				
May 3	To Cash, Application for 40,000 shares returned . .	4,000	0	0	May 1	By Cash, Application for 200,000 shares	20,000	0	0
	" Ordinary Share Capital Account	30,000	0	0	10	" Cash, Allotment money on 110,760 shares .	16,966	0	0
	" Premium on Shares Account .	3,000	0	0	June 29	" Forfeited Shares Account . .	28	0	0
						" Premium on Shares Account	6	0	0
	£	37,000	0	0		£	37,000	0	0

First Call Account

Date		£	s.	d.	Date		£	s.	d.
19..					19 .				
June 3	To Ordinary Share Capital Account .	30,000	0	0	June 10	By Cash on 119,460 shares . .	29,865	0	0
					29	" Forfeited Shares Account, 240 Shares . .	60	0	0
					July 30	" Forfeited Shares Account, 300 shares .	75	0	0
	£	30,000	0	0		£	30,000	0	0

Second Call Account

Date		£	s.	d.	Date		£	s.	d.
19..					19..				
July 4	To Ordinary Share Capital Account .	14,970	0	0	July 10	By Cash on 119,260 shares . .	14,907	10	0
					30	" Forfeited Shares Account, 300 shares . .	37	10	0

FORFEITED SHARES ACCOUNT

19 .		£	s.	d.	19 .		£	s.	d.
June 29	To Application and Allotment Account, 240 shares .	28	0	0	June 29	By Ordinary Share Capital Account, 240 shares . .	120	0	0
	„ First Call Account, 240 shares .	60	0	0	July 30	„ Ordinary Share Capital Account, 300 shares .	187	10	0
July 30	„ First Call Account, 300 shares .	75	0	0					
	„ Second Call Account, 300 shares .	37	10	0					
Aug. 15	„ Ordinary Share Capital Account .	25	10	0					
	„ Premium on Shares Account .	31	10	0					
	„ Balance, amount paid on remaining 200 shares, c/d .	50	0	0					
		£307	10	0			£307	10	0

Note. The entries will be clarified if the reader will direct his attention to the individual accounts in the Share Ledger, which would give the following information (so far as relevant)—

A

	£	s.	d.		£	s.	d.
To Share Capital—amount due on application and allotment on 240 shares	60	0	0	By Cash on application for 320 shares .	32	0	0
„ Premiums thereon .	6	0	0	„ Forfeited Shares Account .	28	0	0
				„ Premium written back . .	6	0	0
	£66	0	0		£66	0	0
To First Call . .	60	0	0	By Forfeited Shares Account . .	60	0	0

B

	£	s.	d.		£	s.	d.
To Share Capital—300 shares . . .	75	0	0	By Cash on application (400 shares)	40	0	0
„ Premium . .	7	10	0	„ Cash on allotment.	42	10	0
	£82	10	0		£82	10	0
To First Call . .	75	0	0	By Forfeited Shares Account . .	112	10	0
„ Second Call . .	37	10	0				

C

	£	s.	d.		£	s.	d.
To Share Capital . .	50	0	0	By Cash on application and allotment .	55	0	0
„ Premium . .	5	0	0				
To First Call . .	50	0	0	By Cash . . .	50	0	0
„ Second Call . .	25	0	0				

Note. C presumably did not take up his shares by application and allotment, as fractions would have arisen; unless it be that he had paid up the amount due on some of his shares.

The premium on reissue is arrived at as follows—

	£	s	d.
Amount paid on 240 shares by A .	32	0	0
,, ,, ,, ,, D .	132	0	0
,, ,, 100 ,, B .	25	0	0
,, ,, ,, ,, F .	55	0	0
	244	0	0
Amount credited as paid thereon, 12s 6d. per share	212	10	0
Premium on Reissue . . .	£31	10	0

RETURN OF ALLOTMENTS

Whenever a company limited by shares makes any allotment of its shares, it must, within one month, deliver to the Registrar of Companies for registration (*a*) a return of allotments, stating the number and nominal amount of the shares comprised in the allotment, the names, addresses, and descriptions of the allottees, and the amount, if any, paid or due and payable on each share, and

(*b*) In the case of shares allotted as fully or partly paid up otherwise than in cash, a contract in writing constituting the title of the allottee to the allotment together with any contract for sale, or for services or other consideration in respect of which that allotment was made, such contracts being duly stamped, and a return stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up, and the consideration for which they have been allotted.

Where the contract is not in writing, the prescribed particulars must be filed, stamped with the same duty as a written contract would attract.

Illustrations. Further examples of the matters mentioned in this chapter are now added in the

form of representative examination questions. From these, readers should be able to appreciate exactly how to deal with anything likely to arise in practice.

(1) *C Ltd. made an issue, which was fully subscribed, of £200,000 4 per cent First Mortgage Debenture Stock at 98 per cent.*

The lists opened and closed and the stock was allotted on 31st July, subscriptions being payable 10 per cent on application, 40 per cent on allotment, 25 per cent on 1st September, and 23 per cent on 31st December.

Under the terms of the issue, payment could be made in full on 1st September, interest on any amounts prepaid being allowable at the rate of $1\frac{1}{2}$ per cent per annum; such interest was not deductible from the subscriber's payment, but was payable by the company on 31 December.

The allottees of one-half of the stock took advantage of the prepayment terms. The others paid on the due dates.

Journalize the entries to be made in the company's books. Ignore income tax.

JOURNAL

		£	£
	Cash . . . . . . *Dr.* To Application and Allotment Account . . . . . . Cash received on application on £200,000 4% First Mortgage Debenture Stock.	20,000	20,000
July 31	Application and Allotment Account *Dr.* To 4% First Mortgage Debenture Stock Account . . . 10% due on application and 40% on allotment on £200,000 Stock allotted this day.	100,000	100,000

JOURNAL—*contd.*

		£	£
	Cash . . . . . . *Dr.* To Application and Allotment Account . . . . . Cash received on allotment.	80,000	80,000
	Discount on Issue of Debentures Account . . . . . . *Dr.* To 4% First Mortgage Debenture Stock Account . . . Discount of 2% on the issue of £200,000 as per terms of issue.	4,000	4,000
Sept. 1	First Instalment Account . . *Dr.* To 4% First Mortgage Debenture Stock Account . . . Instalment of 25% due this day.	50,000	50,000
	Cash . . . . . . *Dr* To First Instalment Account . . ,, Second Instalment Account . Cash received on first instalment and payment in advance in respect of second instalment.	73,000	50,000 23,000
Dec. 31	Second Instalment Account . . *Dr.* To 4% First Mortgage Debenture Stock Account . . . Instalment of 23% due this day.	46,000	46,000
	Cash . . . . . . *Dr.* To Second Instalment Account . Balance of cash received on second instalment	23,000	23,000
	Interest on Instalment paid in Advance Account . . . . . *Dr.* To Cash . . . . . . Interest at 1½% per annum on £23,000 for 4 months.	115	115

Note. In practice the cash would not be journalized.

(2) *A limited company purchased certain patents under an agreement dated* 15*th July, at a cost of* £110,000, £10,000 *of which was to be paid to the vendor in cash and* £100,000 *in fully-paid* £10 *Ordinary Shares. Further Capital was issued to the public to the extent of* £200,000, *as follows*—

£150,000 in £10 Ordinary Shares payable as to £1 on application, £4 on allotment and £5 at the end of three months.

£50,000 in 5 per cent Preference Shares of £25 each, payable as to £5 on application, £10 on allotment, and £10 at the end of three months.

The patents passed to the company in accordance with the agreement on 31st July, which was also the date of allotment. The shares were fully subscribed and duly paid for; the cash being paid direct to the company's bankers, with the exception of 10 Ordinary Shares, which were forfeited for non-payment of the last call.

Make the necessary Cash Book and Journal entries to give effect to the above transactions, post to the proper Ledger accounts, and prove by a Trial Balance the correctness of your entries.

CASH BOOK

		£			£
July 15	To Ordinary Share Application and Allotment Account, £1 per share on 15,000 shares on application	15,000	July 31	By Vendor .	10,000
	" Preference Share Application and Allotment Account, £5 per share on 2,000 shares, on application	10,000	Oct. 31	" Balance c/d .	189,950
July 31	" Ordinary Share Application and Allotment Account, £4 per share on 15,000 shares, on allotment	60,000			
	" Preference Share Application and Allotment Account, £10 per share on 2,000 shares, on allotment.	20,000			
Oct. 31	" Ordinary Share Call Account, £5 per share on 14,990 shares	74,950			
	" Preference Share Call Account, £10 per share on 2,000 shares	20,000			
		£199,950			£199,950
Nov. 1	To Balance b/d . .	189,950			

JOURNAL

		£	£
July 15	Patents . . . . . . *Dr.*	110,000	
	To Vendor		110,000
	Purchase of patents per agreement of this date.		
31	Application and Allotment Accounts *Dr.*		
	Ordinary Shares, £1 on application and £4 on allotment on 15,000 shares allotted this day	75,000	
	Preference Shares, £5 on application and £10 on allotment on 2,000 shares allotted this day.	30,000	
	To Ordinary Share Capital Account		75,000
	,, Preference Share Capital Account		30,000
	Vendor . . . . . . *Dr*	100,000	
	To Ordinary Share Capital Account		100,000
	Allotment of 10,000 fully paid £10 Ordinary Shares in part satisfaction of purchase consideration of patents		
Oct. 31	Call Account, Ordinary Shares . *Dr.*	75,000	
	,, ,, Preference Shares . *Dr.*	20,000	
	To Ordinary Share Capital Account		75,000
	,, Preference Share Capital Account		20,000
	Amounts due per terms of issue, viz. £5 per share on 15,000 Ordinary Shares and £10 per share on 2,000 Preference Shares		
Nov	Ordinary Share Capital Account . *Dr*	100	
	To Forfeited Shares Account . .		100
	Forfeited Shares Account . . *Dr.*	50	
	To Call Account, Ordinary Shares .		50
	Forfeiture of 10 Ordinary Shares, £10 called, for non-payment of call of £5 per share as per resolution of directors.		

LEDGER

Patents Account

		£			
July 15	To Vendor .	110,000			

Ordinary Share Capital Account

		£			£
Nov.	To Forfeited Shares Account . .	100	July 31	By Application and Allotment Account .	75,000
	,, Balance c/d . .	249,900		,, Vendor . . .	100,000
			Oct. 31	,, Call Account . .	75,000
	£	250,000		£	250,000
			Nov.	By Balance b/d . .	249,900

Preference Share Capital Account

						£
			July	31	By Application and Allotment Account	30,000
			Oct.	31	,, Call Account . .	20,000
						£50,000

Ordinary Share Application and Allotment Account

			£				£
July	31	To Share Capital Account	75,000	July	15	By Cash .	15,000
				,,	31	,, Cash . . .	60,000

Preference Share Application and Allotment Account

			£				£
July	31	To Share Capital Account	30,000	July	15	By Cash . . .	10,000
				,,	31	,, Cash . . .	20,000

Ordinary Share Call Account

			£				£
Oct.	31	To Share Capital Account	75,000	Oct	31	By Cash . . .	74,950
				Nov.		,, Forfeited Shares Account . .	50

Preference Share Call Account

			£				£
Oct.	31	To Share Capital Account	20,000	Oct.	31	By Cash . .	20,000

Forfeited Shares Account

			£				£
Nov.		To Ordinary Share Call Account . .	50	Nov.		By Ordinary Share Capital Account .	100
		,, Balance c/d . .	50				
				Nov.		By Balance b/d . .	50

Vendor

			£				£
July	31	To Cash . .	10,000	July	15	By Patents Account .	110,000
		,, Ordinary Share Capital Account . .	100,000				
		£	110,000			£	110,000

TRIAL BALANCE

	Cr.	Dr.
	£	£
Cash	189,950	
Patents	110,000	
Ordinary Share Capital . .		249,900
Preference Share Capital . .		50,000
Forfeited Shares . . .		50
	£299,950	£299,950

The above example introduces an allotment of shares for a consideration other than cash. The assignment of the patents should be in duplicate in order that one copy can be delivered to the Registrar of Companies with the Return of Allotments.

(3) *On* 1st *January, the London Manufacturing Company Ltd. was registered with a nominal capital of* 600,000 *Ordinary Shares of* £1 *each. On* 5*th January,* 100,000 *of these shares were allotted at par, the cash being paid in full forthwith. In November the balance of the nominal capital was offered to the public at a premium of* 5*s. per share, the whole issue having been underwritten at the same price, the underwriting commission being* 2 *per cent. Only* 280,000 *shares were subscribed by and allotted to the public, the balance being allotted to the underwriters. Five shillings per share was payable on application,* 5*s. per share on allotment, and a first call of* 7*s.* 6*d. per share was payable on* 15*th December. The whole of the moneys due from the public were paid; the underwriters had paid the application and allotment money, but had not paid their first call before the end of the year.*

Give the necessary journal entries for these transactions and show how they would appear in the company's Balance Sheet at 31*st December.*

LONDON MANUFACTURING COMPANY, LTD.
JOURNAL

		£	£
Jan. 5	Cash . . . . . . *Dr.* To Application and Allotment Account . . . . . . Cash received in full on application for 100,000 Shares.	100,000	 100,000
	Application and Allotment Account *Dr.* To Ordinary Share Capital Account Allotment of 100,000 Ordinary Shares at par as per minute of this day	100,000	 100,000
Nov. 1	Cash . . . . . . *Dr* To Application and Allotment Account . . . . . . 5s. per Share received on application for 500,000 Shares.	125,000	 125,000
	Application and Allotment Account *Dr.* To Ordinary Share Capital Account ,, Premium on Shares Account . Allotment of 500,000 Shares at £1 5s per share, payable 5s. per share on application and 5s. per share (being premium) on allotment, as per minute of this day.	250,000	 125,000 125,000
	Cash . . . . . . *Dr.* To Application and Allotment Account . . . . . . Cash received on allotment.	125,000	 125,000
Dec. 15	First Call Account . . . . *Dr* To Ordinary Share Capital Account Call of 7s. 6d. per share on 500,000 shares.	187,500	 187,500
	Cash . . . . . . *Dr.* To First Call Account . . . . Cash received on First Call being 7s. 6d. per share on 280,000 shares	105,000	 105,000
√	Underwriting Commission Account *Dr.* To Underwriter's Account . . Underwriting Commission of 2% on 500,000 shares issued at 25s. per share, as per contract dated..	12,500	 12,500

BALANCE SHEET
AS AT 31ST DECEMBER

Liabilities		£	Assets	£
Authorized Capital— 600,000 Shares of £1 each		600,000	Cash	455,000
Issued Capital— 100,000 Ordinary Shares of £1 each, fully paid		100,000	Underwriting Commission	12,500
500,000 Ordinary Shares of £1 each, 12s. 6d. per share called up	£312,500			
Less Calls in arrear	82,500			
		230,000		
		330,000		
Premium on Shares Account		125,000		
Underwriters for Commission		12,500		
£		467,500	£	467,500

Notes. (1) It has been assumed that the premium on shares was payable on allotment.

(2) It has been assumed that under the provisions of the Underwriting Contract, the Underwriting Commission is to be computed on the full issue price of the shares, including the premium.

(4) *The directors of a company, of which you are auditor, forfeited* 1,000 *Ordinary Shares of* £1 *each upon which* £500 *had been paid. The shares were reissued to one of the directors upon payment of* £750. *No entries appeared in the books with reference to the forfeiture, which you discovered when examining the Minute Book, the amount received being posted to the credit of capital.*

What entries would you suggest should be made to put the matter in order?

The effect of the entry which has been made in the books is to increase the share capital to a figure in excess of the nominal value of the shares issued. At the same time a debit balance on one or more call accounts has been allowed to remain.

The following entries should be made to adjust the position. (It is assumed that the shares are reissued as fully paid and that forfeiture took place for the non-payment of a call or calls amounting to 10s. per share.)

		£	£
	Share Capital Account . . Dr. To Forfeited Shares Account . . Forfeiture of 1,000 shares of £1 each for non-payment of call of 10s. as per minute dated	1,000	1,000
	Forfeited Shares Account . . Dr To Call Account . . . . Call unpaid transferred.	500	500
	Forfeited Shares Account . . Dr. To Share Capital A/c . . . To increase the credit to Share Capital to nominal value of shares issued. (*Note*. Share Capital was credited with £750 only in respect of 1000 shares reissued.)	250	250.

The balance of £250 remaining to the credit of Forfeited Shares Account is a capital profit to the Company. It should preferably be transferred to a Capital Reserve, or utilized to write down fictitious assets.

(5) *YZ & Co. Ltd. have an issued capital of* £200,000 *in Ordinary Shares of* £1 *each, and make up their accounts annually as on* 30*th September.*

On 30*th September,* 1937, *the following balances* (inter alia) *stood in their books*—

		£
Profit and Loss Account . . .	*Cr.*	37,351
Dividend Account No. 16 . . .	*Cr.*	160
do. *No.* 17 . . .	*Cr.*	1,212
Dividends Unclaimed . . .	*Cr.*	527
Dividend Cash Account . . .	*Dr.*	1,372
Deposit Account for Dividends Unclaimed	*Dr.*	527

At the Annual General Meeting held on 10*th January,* 1938, *a final dividend* (*No.* 18) *of* 15 *per cent less tax was declared in respect of the year to* 30*th September,* 1937, *warrants being posted on the next day.*

On 15*th August,* 1938, *the directors declared an interim dividend* (*No.* 19) *of* 5 *per cent less tax.*

During the year ended 30th September, 1938, the following warrants were presented to the company's bankers for payment—

Dividend No. 12	. .	£27
,, 16	. .	124
,, 17	. .	1,108
,, 18	. .	23,736
,, 19	. .	7,460

On 30th September, 1938, the outstanding balances of dividends Nos. 16 and 17 were transferred to the Unclaimed Dividends Account.

You are required to write up the various accounts affected by the above transactions, bringing down balances where possible. Assume Income Tax at 4s. in £.

No Journal entries are required.

DIVIDEND ACCOUNT, No. 16

		£			£
1938 Sept. 30	To Cash . . .	124	1937 Sept. 30	By Balance b/f . .	160
	,, Unclaimed Dividends Account .	36			

DIVIDEND ACCOUNT, No. 17

		£			£
1938 Sept. 30	To Cash	1,108	1937 Sept. 30	By Balance b/f . .	1,212
	,, Unclaimed Dividends Account . .	104			

DIVIDEND ACCOUNT, No. 18

		£			£
1938 Jan. 10	To Income-tax Account .	6,000	1938 Jan. 10	By Profit and Loss Account . . .	30,000
Sept. 30	,, Cash . . .	23,736			
	,, Balance c/d . .	264			
			Oct. 1	By Balance b/d . .	264

DIVIDEND ACCOUNT, No. 19

		£			£
1938 Aug. 15	To Income-tax Account .	2,000	1938 Aug. 15	By Profit and Loss Account . . .	10,000
Sept. 30	,, Cash . . .	7,460			
	,, Balance c/d . .	540			
			Oct. 1	By Balance b/d . .	540

PROFIT AND LOSS ACCOUNT

		£			£
1938 Jan. 10	To Final Dividend No. 18	30,000	1937 Sept. 30	By Balance b/f . .	37,351
Aug. 15	„ Interim Dividend No 19 . .	10,000			

DIVIDENDS UNCLAIMED ACCOUNT

		£			£
1938 Sept. 30	To Dividend Cash Account . .	27	1937 Sept. 30	By Balance b/f . .	527
	„ Balance c/d	640	1938 Sept. 30	„ Transfer—No. 16 .	36
				„ do. No. 17 .	104
			1938 Oct. 1	By Balance b/d .	640

DEPOSIT ACCOUNT (for Dividends Unclaimed)

		£			£
1937 Sept. 30	To Balance b/f . .	527	1938 Sept. 30	By Dividend Cash Account, No. 12 .	27
1938 Sept. 30	„ Cash . . .	140		„ Balance c/d . .	640
Oct. 1	To Balance b/d . .	640			

DIVIDEND CASH ACCOUNT

		£			£
1937 Sept. 30	To Balance b/f . .	1,372	1938 Sept 30	By Dividend Account—Unclaimed	27
1938 Jan. 10	„ Cash—No. 18 .	24,000		No. 16 .	124
Aug. 15	„ do. No. 19 . .	8,000		No. 17 .	1,108
Sept. 30	„ Deposit Account	27		No. 18 . .	23,736
				No. 19 . .	7,460
				„ Deposit Account for Dividends unclaimed	140
				„ Balance c/d .	804
		£33,399			£33,399
Oct. 1	To Balance b/d .	804			

Note. Since the balances of Dividend Accounts, 16 and 17, were transferred to Dividends Unclaimed Account, an equal amount of cash should be transferred to Deposit Account for Unclaimed Dividends.

(6) *A company took power in its Articles to receive payment of calls in advance and £2,000 was so received. At the end of the year it was found that no profit had been made.*

What interest, if any, should be paid in respect of the calls in advance? Give any entries (pro forma)

you would put through the company's books. Income-tax to be taken at 4s. 6d. in the £.

(See Chapter VIII.)

The rate of interest payable on calls in advance depends upon the provisions of the Articles. If these are silent, and Table A has not been expressly excluded, the rate of interest must be agreed upon between the directors and the shareholders who paid in advance, but must not exceed 6 per cent per annum without the consent of a general meeting. Such interest is payable whether there are profits out of which to meet it or not; if necessary, it must be paid out of capital. (*Lock* v. *Queensland Investment and Land Mortgage Co.* (1896), App. Ca. 461.)

If, however, Table A is barred by the Articles, and the Articles themselves are silent as to interest, the defect may be remedied by a Special Resolution.

PRO FORMA JOURNAL ENTRIES

		£	s.	d.	£	s.	d.
	Interest on Calls in Advance *Dr.*	60	0	0			
	To Sundry Shareholders Account . . .				46	10	0
	Income Tax Account .				13	10	0
	Interest at 6% per annum on £2000 paid in advance of calls, *less* Income-tax at 4s. 6d. in £ for the six months ended 31st December.						
	Sundry Shareholders . *Dr.*	46	10	0			
	To Cash				46	10	0
	Satisfaction of amount due.						
	Profit and Loss Account . *Dr*	60	0	0			
	To Interest on Calls in Advance.				60	0	0
	Transfer of Interest.						

(7) *Blank Ltd., registered under Table A, was formed with an Authorized Capital of* 200,000 *Ordinary Shares of* £1 *each.*

On 1st *July,* 1936, 100,000 *shares were issued, fully paid, to the vendors and* 80,000 *were subscribed for by the public. On the latter,* 5s. *a share was*

payable on application, 2s. 6d. on allotment, 5s. on the first call, due on 1st September, and 2s. 6d. on the second call, due on 1st November, 1936.

On the shares subscribed for by the public there had been paid on 30th June, 1937—

On 60,000	*Shares,*	*the full amount called*	
,, 18,000	,,	12s. 6d. *a share*	
,, 500	,,	7s. 6d	,,
,, 1,500	,,	5s	,,

On 30th June, 1937, the directors forfeited the shares on which less than 10s. had been paid.

The calls in arrear on the 18,000 shares were collected on 31st July, 1937, and on 1st October, 1937, the directors made a call of the remaining 5s. a share, payable on 1st December; the whole sum due thereon was received on that date.

On 31st January, 1938, the forfeited shares were reissued, fully paid up, to A. M. at the price of 15s. a share, which he paid the next day.

Submit Journal entries recording all the above transactions (except cash entries) and set out the capital items as they should appear in the company's Balance Sheets as on 30th June, 1937 and 1938.

JOURNAL

		£	s.	d.	£	s.	d.
1936 July 1	Vendors . . . . *Dr.*	100,000	0	0			
	To Share Capital Account .				100,000	0	0
	Allotment of 100,000 £1 shares, fully paid, to Vendors per minute of this day.						
	Application and Allotment Account . . . . *Dr.*	30,000	0	0			
	To Share Capital Account .				30,000	0	0
	Amount due on application (5s.) and allotment (2s. 6d.) on 80,000 £1 shares allotted this day.						

JOURNAL—*contd.*

Date	Particulars	£	s.	d.	£	s.	d.
1936 *say* Aug. 14	First Call Account . . *Dr.*	20,000	0	0			
	To Share Capital Account .				20,000	0	0
	Call of 5s. on 80,000 £1 shares payable 1st September, per minute of this day.						
say Oct. 14	Second Call Account . *Dr.*	10,000	0	0			
	To Share Capital Account .				10,000	0	0
	Call of 2s. 6d. per share on 80,000 £1 shares, payable 1st November, per minute of this day.						
1937 June 30	Share Capital Account . *Dr.*	1,500	0	0			
	To Forfeited Shares Account				1,500	0	0
	Forfeiture per minute of this day of 2,000 shares for non-payment of amounts due thereon.						
	Forfeited Shares Account *Dr.*	937	10	0			
	To Application and Allotment Account . .				187	10	0
	,, First Call Account .				500	0	0
	,, Second Call Account .				250	0	0
	Amounts unpaid on shares forfeited.						
Oct. 1	Final Call Account . . *Dr.*	19,500	0	0			
	To Share Capital Account .				19,500	0	0
	Final Call of 5s. per share on 78,000 shares, payable 1st December, per minute of this date.						
1938 Jan. 31	A. M. . . . . . *Dr.*	1,500	0	0			
	Forfeited Shares Account .	500	0	0			
	To Share Capital Account .				2,000	0	0
	Reissue of 2,000 shares which were forfeited on 30th June, 1937, as fully paid for 15s. per share, per minute of this day.						
	Forfeited Shares Account *Dr.*	62	10	0			
	To Premium on Forfeited Shares Reissued Account				62	10	0
	Profit on reissue transferred.						

CAPITAL ITEMS IN BALANCE SHEETS

		£	s.	d.
Authorized—200,000 Ordinary Shares of £1 each .		200,000	0	0
At 30th June, 1937—				
Issued: 100,000 Ordinary Shares of £1 each, fully paid		100,000	0	0
78,000 Ordinary Shares of £1 each, 15s called up .	£58,500			
Less Calls in arrear .	2,250			
		56,250	0	0
		156,250	0	0
Forfeited Shares Account		562	10	0
At 30th June, 1938—				
Issued: 180,000 Ordinary Shares of £1 each, fully paid		180,000	0	0
Premium on Forfeited Shares reissued.		62	10	0

(8) The Orient Trading Co. Ltd. issued a prospectus offering 200,000 *Ordinary Shares of* 10s. *each for subscription on the following terms*—

	s	d.	
On Application		6	*per share*
On Allotment (including a premium of 2s. per share)	3	6	,,
On first Call (3 months after allotment) . .	4	0	,,
On second Call (6 months after allotment) . .	4	0	,,
	12	0	

Subscriptions were received for 317,000 *shares on 23rd April, and the directors proceeded to allotment on 30th April as follows*—

	Shares allotted
(1) *Allotments in full. (Two applicants paid in full on allotment in respect of* 4000 *shares each)* .	38,000
(2) *Allotments of two-thirds of shares applied for* .	160,000
(3) *Allotments of one-fourth of shares applied for* .	2,000

Cash amounting to £775 (being application moneys received with applications for 31,000 *shares upon which no allotments were made) was returned to applicants on 6th May.*

Cash received in advance of calls was retained until the due dates. The amounts due on allotment,

and first and second calls were transferred to the general funds of the company on the 15th of May, August, and November, respectively; the whole of the cash due was received prior to those dates.

You are required to show—

(1) *The Cash Account (in summary form) relating to the issue, and*

(2) *The Application and Allotment, and Call Accounts.*

(*Journal entries are not required.*)

ORDINARY SHARE ISSUE CASH ACCOUNT

			£				£
Apr.	23	To Application and Allotment Account, 6d. per share on 317,000 shares	7,925	May	6	By Application and Allotment Account, Return of Application Money on 31,000 shares	775
May		,, Do. Allotment money: 3s. 6d. per share on— 38,000 shares	6,650	,,	15	,, General Cash	40,000
		160,000 ,,	26,000	Aug.	15	,, ,,	40,000
		2,000 ,,	200	Nov.	15	,, ,,	40,000
		,, Calls in Advance Account—8s per share on 8000 shares	3,200				
Aug.		,, First Call Account	38,400				
Nov.		,, Second Call Account	38,400				
		£	120,775			£	120,775

APPLICATION AND ALLOTMENT ACCOUNT

			£				£
Apr	30	To Share Capital Account, 2s. per share on 200,000 shares	20,000	Apr.	23	By Cash, Application Money, 6d. per share on 317,000 shares	7,925
		,, Premiums on Shares account, 2s. per share on 200,000 shares	20,000	May		,, Cash, Allotment Money	32,850
May	6	,, Cash, Application Money returned on 31,000 shares	775				
			£40,775				£40,775

FIRST CALL ACCOUNT

			£				£
July	30	To Share Capital Account, 4s. per share on 200,000 shares	40,000	July	30	By Calls in Advance Account, 4s. per share on 8000 shares	1,600
				Aug.		,, Cash	38,400
			£40,000				£40,000

SECOND CALL ACCOUNT

		£			£
Oct. 30	To Share Capital Account, 4s. per share on 200,000 shares .	40,000	Oct. 30	By Calls in Advance Account, 4s. per share on 8000 shares	1,600
				" Cash . .	38,400
		£40,000			£40,000

(9) *B Co. Ltd., registered under Table A, had a capital of £50,000 in £1 shares. The shares were issued at par, on 1st July, 1936, and fully subscribed, 12s. per share being payable on application and the balance on allotment. The allotments were made on 3rd July.*

The allottees of 10,000 of the shares did not pay the 8s. per share due on allotment, and the shares were declared forfeited on 31st March, 1937.

A dividend of 1s. per share in respect of the year ended 30th June, 1937, was declared on 23rd July 1937.

The forfeited shares were reissued on 1st August, 1937, at 25s. per share for cash.

(a) Record these transactions in the company's books by Journal entries; and

(b) Show how they would be reflected in the company's Balance Sheet on 30th June, 1937.

Assume Income Tax at 4s. 6d. in £.

JOURNAL

		£	£
1936 July 1	Cash . . . . . . *Dr.*	30,000	
	To Applications and Allotment Account		30,000
	Receipt of 12s. per share on applications for 50,000 shares of £1 each.		
3	Application and Allotment Account *Dr.*	50,000	
	To Share Capital Account . .		50,000
	Par value due on 50,000 £1 shares allotted this day, per minute.		

JOURNAL—(*contd.*)

		£	£
1936 July 3	Cash . . . . . . *Dr.*	16,000	
	To Application and Allotment Account		16,000
	Receipt of allotment money of 8s. per share on 40,000 shares.		
1937 Mar. 31	Share Capital Account . . *Dr.*	10,000	
	To Forfeited Shares Account . .		10,000
	Forfeiture of 10,000 £1 shares for non-payment of allotment money, per minute.		
	Forfeited Shares Account . . *Dr.*	4,000	
	To Application and Allotment Account		4,000
	Transfer of amount unpaid on shares forfeited.		
July 23	Profit and Loss Appropriation Account . . . . . *Dr.*	2,000	
	To Dividend Account . . .		2,000
	Dividend of 1s. per share declared this day on 40,000 shares registered in the names of members.		
	Dividend Account . . . *Dr*	450	
	To Income-tax Account . .		450
	Transfer of tax at 4s. 6d. in £		
	Dividend Account . . . *Dr.*	1,550	
	To Cash		1,550
	Payment of net dividend.		
Aug. 1	Cash . . . . . . *Dr.*	12,500	
	To Share Capital Account . .		10,000
	,, Premium on Forfeited Shares Reissued Account . . .		2,500
	Reissue of 10,000 £1 shares, credited as fully paid, for 25s. each.		
	Forfeited Shares Account . . *Dr.*	6,000	
	To Premium on Forfeited Shares Reissued Account . . .		6,000
	Transfer of amount paid by original holder.		

(Extracts from) BALANCE SHEET AS AT 30TH JULY, 1937

Liabilities

	£	£
Share Capital—		
Authorized: 50,000 Shares of £1 each . .	**£50,000**	
Issued: 40,000 Shares of £1 each, fully paid .		**40,000**
Forfeited Shares Account		**6.000**

CHAPTER IV

ACQUISITION OF A BUSINESS

PURCHASE of a business—Goodwill—Profits prior to incorporation—Statutory report

WHERE a business is to be acquired, the company must see that the assets are revalued on a going concern basis, that the liabilities that are being taken over are properly stated, and that a proper valuation is placed upon goodwill. Goodwill is usually the most difficult asset to value, and before proceeding to discuss the accounting records involved, it is proposed to deal briefly with the nature and valuation of this asset.

GOODWILL

Goodwill has been defined in many ways, each perhaps appropriate to the particular case, but none really comprehensive. Possibly the best definition is that "Goodwill is that attribute of a business which enables super profits to be earned, and which may arise from a number of causes, e.g. reputation, location, business connexions, name, personality, etc." This is much more comprehensive than the often quoted: "Goodwill is nothing more than the probability that the old customer will resort to the old place," i.e. "the disposition of the person to return to the place where he has been well served."

The term "super-profits" is used to denote the profits earned in excess of the minimum yield required as compensation for interest on capital, risk, and reward of services.

The definition first given indicates that there is only "goodwill," in the accounting sense, where the profits exceed those normally required from a business to make it worth while to carry it on at all. In other words, what we are speaking about here is *saleable* goodwill. Personal skill cannot be sold, hence in a professional business the price paid for goodwill is really a premium paid for introductions to clients, in the hope that they will continue to patronize the firm irrespective of the change of ownership. Goodwill has been divided by one writer into groups, viz.—

(1) Commercial goodwill, i.e. the favourable attitude or reactions of customers.

(2) Industrial goodwill, i.e. the willingness of employees to work for one employer as against competing employers.

(3) Financial goodwill, i.e. the favourable attitude of credit institutions and investors.

The factors which go to build up commercial goodwill take many forms. It is often difficult to give any one reason or group of reasons for the reputation gained by an old-established and efficiently conducted business, e.g. the type of service and the way it is performed; the advertising done; collateral services, strictly outside the bare contract entered into, but nevertheless helpful to and appreciated by customers; suitable location of premises; habit ingrained in customers; "household word" trade-marks; quasi monopoly; and many other factors, all enter into the question.

In a comparatively newly set up business, a valuable goodwill may exist for somewhat similar

reasons, though the continuance of the goodwill may then depend upon whether or not habit has been ingrained sufficiently. In many businesses, it is possible to build up sales by heavy and continuous advertising; whether or not this results in goodwill is another matter, dependent upon the profits made on the volume of work done.

Industrial goodwill is not merely the result of personality; it involves the expenditure of time and money on welfare work, pension funds, improved working conditions, facilities for recreation, clubs, sports grounds, etc., and the tactful handling of disputes. The result of such expenditure should emerge in the form of lower costs, owing to increased production, directly affecting super-profits.

Financial goodwill is almost wholly a question of the reputation of the management for efficiency and integrity. The ability to obtain capital cheaply obviously affects super-profits.

It is not possible in a work which is essentially one on accounting to go more deeply into the nature of goodwill, a subject on which whole books have been written. Accordingly, we now turn to the question of valuation of goodwill.

VALUATION OF GOODWILL

The purchaser of a business as a going concern must in the first place agree upon the valuation of the assets which he is going to take over. The price he is willing to pay for these is governed by their earning capacity, i.e. he is not willing to pay a price in excess of that which will enable him to earn a fair return upon the capital involved. If the return he expects to gain is more than the

minimum that he sets, he is going to earn super-profits. Since these super-profits are the result of the goodwill built up by the vendor, the purchaser is willing to pay a fair price for the right to them.

It will be noticed that we have spoken of what the purchaser *expects* to earn. He does not pay for a goodwill measured by past profits, but for a goodwill measured by estimated future profits. Naturally, however, past profits must be used as an indication of what the business can do, and must be adjusted by reference to the facts as they will appear in the purchaser's hands. Due consideration must be given to the changes he intends to make in personnel, methods, etc.

It is thus necessary to adjust the profits of a representative number of past years into terms of recurring profits on the basis of what the purchaser is going to do. A representative number of past years must be looked at; one year is not enough, as it may be far from normal. On the other hand, too long a period must not be taken, as the conditions of the earlier years may be so different from current conditions as to make their results of little significance. In arriving at estimated future profits, nothing should be added to the price for increases expected as a result of the purchaser's own efforts; he is only expected to pay for super-profits accruing as a result of the efforts of the vendor.

From the estimated profits, there must be deducted a fair rate of interest on the capital that will be locked up in the business. What is a fair rate depends entirely upon the nature of the business; it must be sufficient to cover the risk attached to the business, e.g. in a business selling

necessaries, the risk is much less than that in a business selling luxuries. In every case, the rate must be more than that to be obtained by investment in gilt-edged securities; how much more depending on risk.

There has to be deducted also the fair remuneration of management, i.e. in the case of a company, directors' fees. The balance remaining is the super-profits.

The price to be paid can now be determined on some selected basis. In the past, this has commonly been "so many years' purchase," and that basis is still extensively employed. The number of years to be taken is a difficulty, however, and depends upon the facts of the case.

In essence, the purchaser is buying an annuity of super-profits. Accordingly, his capital expenditure is a wasting asset; the goodwill that he purchases will gradually disappear. As it disappears, however, he will be building up his own goodwill, otherwise his business will decline. Obviously, then, the purchaser is not willing to pay for an annuity in perpetuity; the annuity (the super-profits) must give him not only a fair return on the capital spent in buying it and remuneration of management, but also a sufficient surplus whereout to set aside a sinking fund to replace such capital, over the number of years that he estimates it will take for his new goodwill to have replaced completely the old. The difficulties involved are obvious, and, in practice, the number of years are fixed by bargaining.

Alternatively, it may be argued that the return expected on capital locked up in the goodwill must

be at least as much as that expected upon capital paid for other assets, and the goodwill is capitalized accordingly.

It is usually considered, however, that the normal rate of return on an investment in super-profits should be higher than on an investment in normal profits, owing to the "sinking fund" requirements mentioned above.

It must be admitted that, in practice, no very exact method of arriving at goodwill has been adopted in many cases, but more precise attention is to-day being paid to this question. Compromise still very largely fixes the final figure. Bearing in mind the fact that items such as stock in trade and plant are not always capable of exact valuation except for immediate sale, a certain amount of elasticity in the valuation of goodwill may not be altogether undesirable.

A further factor in the valuation is whether or not the goodwill is readily transferable. Goodwill has been very ably divided into three types, "cat, dog, and rat," in view of the peculiar habits of these three animals. The cat tends to stick to the abode; "cat" goodwill is therefore that which will adhere to the business which is being transferred, and is the most valuable. The dog follows his master; "dog" goodwill is difficult to transfer, and is correspondingly less valuable. The rat is a migrant; "rat" goodwill is practically valueless, as it represents those customers who have no special ties either to the business or its proprietors, and who may be "here to-day and gone to-morrow." Summed up, cat goodwill is adherent; dog personal, and rat fugitive. Adherent goodwill is only

valuable as attaching to the business or the premises or their immediate neighbourhood; personal goodwill is unsaleable; fugitive goodwill is only valuable in that as one fugitive goes, another may arrive.

The difficulty of separating these three types will be obvious, but some regard must be had to them. One will usually predominate sufficiently, however, to make it possible to see whether there is a real transferable goodwill or not.

Two maxims must be borne in mind, viz. (1) The smaller the capital required to produce a given income, the more valuable the goodwill should be; and (2) the greater the skill required to carry on the business, the lower the value of goodwill. Both maxims suppose, of course, that other things are equal.

For examination purposes, students are expected to show a familiarity with the principles enumerated above, but cannot be expected to be fully acquainted with all the facts which would have to be taken into account in a particular case placed before them in an examination question. The examiner has to confine the information given in the question to a minimum, and the student is therefore at liberty to make reasonable assumptions. So long as he makes a reasoned application of principles, the student need not fear that his result will be unsatisfactory; there can be no cut-and-dried valuation of goodwill, which is alone the right answer.

Even in practice, where all the facts are known, opinions will differ; how much more must they differ in an examination where so many details are left to the student's own assumption? So long

as the assumptions are reasonable, and set out clearly, no fears need be felt on this ground.

In arriving at the rate of interest, that required to keep the ordinary shares of similar concerns at par is a useful guide. The remuneration expected will be that which could be earned for managing a similar concern without any interest in profits.

In some cases, an "all-in" price is agreed for the business as a whole. Where this is so, the price paid for goodwill is the excess of the "all-in" purchase price over the net assets acquired.

Illustrations. (1) *The following was the Balance Sheet of a sole trader on 30th June—*

	£			£
Capital	10,000	*Leasehold Premises*		4,000
Trade Creditors	4,900	*Plant and Machinery*		2,000
Expense Creditors	900	*Furniture and Fixtures*		600
		Stock-in-trade		5,000
		Trade Debtors	3,200	
		Less *Reserve for Doubtful Debts*	160	
				3,040
		Payments in advance		60
		Balance at Bank		1,100
	£15,800			£15,800

A company was formed to acquire the business for £12,000. The assets and liabilities were taken over at the values at which they appeared in the Balance Sheet. Show the amount paid for goodwill.

The amount paid for goodwill is as follows—

	£
Total Assets	15,800
Deduct Creditors	5,800
Net Assets	£10,000

Goodwill is the excess of the purchase price over the net assets, viz. £2,000.

(2) *The Balance Sheet of a partnership was as follows*—

	£	£		£
Capital Accounts—			*Goodwill*	1,000
A	5,000		*Plant*	7,000
B	3,000		*Furniture, etc.*	300
C	2,000		*Stock-in-trade*	4,500
		10,000	*Sundry Debtors*	2,800
Current Accounts—			*Prepayments*	100
A	800		*Bank Balance*	1,900
B	700			
C	1,000			
		2,500		
Sundry Creditors		5,100		
		£17,600		£17,600

It was proposed to form a company to acquire the business. For the purpose of the acquisition, the assets were revalued as follows: Plant £6,000, *Furniture* £400, *Stock* £4,200, *Debtors* £2,500, *Prepayments nil. It was ascertained that the profits, before charging anything in respect of the partners, had, for the past five years, been as follows:* £2,600, £2,900, £3,300, £3,500, £3,000. *Included in these profits were non-recurring items, averaging* £150, *but from the nature of the business, casual non-recurring items were found to arise every year, and the promoters agreed that a figure of* £120 *should be allowed as profits from this source.*

Similar businesses paid a dividend of 8 *per cent per annum on their Ordinary Shares, and the partners, who would be the directors of the company, were worth as remuneration, A* £400, *B* £500, *and C* £600 *per annum.*

Seven years' purchase of the adjusted super-profits was the agreed price for goodwill, the super-profits being taken on the basis of the average of the past five years.

Compute the value of the goodwill.

The average profits are arrived at as follows—

Year.	£	£
1		2,600
2		2,900
3		3,300
4		3,500
5	3,000	
Deduct: Decrease in closing stock (which decreases profit)	300	
		2,700
		£15,000
Average		£3,000
Deduct: Excess of average casual profits over agreed figure £(150 – 120) . . .		30
Total average profits . . .		2,970
Deduct:		
Interest on capital 8% on £9,900 (see below)	792	
Remuneration	1,500	
		2,292
Super-profits		£678

Seven years' purchase thereof, i.e. price to be paid for goodwill, £4,746

The net assets to be acquired are as follows—

	£
Plant	6,000
Furniture, etc. . .	400
Stock-in-trade . .	4,200
Sundry Debtors . .	2,500
Bank Balance . .	1,900
	15,000
Deduct: Creditors .	5,100
	£9,900

(3) *The net assets of a business to be acquired by a company were agreed at a valuation of £80,000. The profits, duly adjusted for the purposes of arriving at the value of goodwill, were £15,000.*

The remuneration to be paid to directors was

£3,000, and the rate of interest required to cover pure interest and risk was 12 per cent.

Compute the value of goodwill.

		£	£
Computation—			
Profits			15,000
Deduct:	Remuneration	3,000	
	Interest, 12% on £80,000	9,600	
			12,600
Super-profits			£2,400

Capitalized at 12 per cent, these give a maximum price of £20,000 $\left(=£2{,}400 \times \frac{100}{12}\right)$ as the amount to be paid for goodwill. This may require to be discounted.

Alternatively, goodwill (maximum) may be arrived at, in the above illustration, as follows—

	£
Profits	15,000
Deduct Remuneration	3,000
Available for interest	£12,000

This would return 12 per cent on $(£12{,}000 \times \frac{100}{12} =)$ which is the maximum price to be paid for the business.	£100,000
Deduct value of net assets	80,000
Maximum value of Goodwill	£20,000

(4) *In the above illustration, let it be assumed that the rate of interest required is 16 per cent.*

The capitalization would then be

$$£12{,}000 \times \frac{100}{16} = £75{,}000.$$

It is obvious, therefore, that there can be no saleable goodwill; indeed it would not be worth

the company's while to purchase the assets for £80,000, as it could not make sufficient profits thereon to earn an adequate reward for the risk involved.

A word of warning is required here, however. Although there may be no transferable *valuable* goodwill, the company *may* be willing to pay the asset prices in order to take over the existing nucleus of business upon which to build a goodwill of its own.

Moreover, the company may be able to obtain part of its capital at less than 16 per cent, and thus earn super-profits. This aspect will be considered in connexion with reconstructions and amalgamations. It is thought that sufficient has been said for the present purpose.

In some cases, the consideration paid for the acquisition of a business is less than the value placed upon the net assets. This results in a paper profit of a capital nature, and it is carried to a Capital Reserve Account. The Capital Reserve may be used to write down assets or for other capital purposes.

Goodwill should not appear in a company's books unless actually purchased, and then not at a price in excess of cost.

The problem then arises as to whether goodwill should be written off, since it is an intangible asset and fluctuates with the fortunes of the business.

Broadly, the position is that if the business is progressing, goodwill remains at its original value or increases in value, i.e. the goodwill purchased is being continually replaced by current goodwill;

as the influence of the vendor disappears, so the purchaser builds his own goodwill. Since the asset is being maintained in value, there appears to be no urgent necessity to write it off.

If the business is retrogressing, the goodwill must inevitably decrease in value, and should be written off. Since there is no legal compulsion to write it off, however, there is more than a temptation not to reduce the profits (or increase the loss) by amounts written off goodwill.

Accordingly, it is commonly found that no provision is made for writing down goodwill, although many authorities consider that it should always be written off, preferably over the number of years taken into account in arriving at the purchase price. The actual goodwill purchased undoubtedly disappears gradually, and the new asset built up in its place cannot be computed exactly, hence any provision for goodwill being written off creates a secret reserve to the extent that actual goodwill exceeds the book value. This is all to the good of the business, since the secret reserve so created is one difficult of secret manipulation, owing to the requirement that goodwill be stated separately on the Balance Sheet.

TRANSFER OF BUSINESS

Once the terms of acquisition have been agreed upon, and the necessary capital raised, the company will enter into the agreement for the transfer of the business. In this connexion, it is well to remember that where a business is being taken over as a going concern, all bank and cash balances

are taken over as part of the assets, unless expressly excluded. This is a practical step which avoids any difficulty as to the valuation of debts, since any collected or paid in the interval between the date when the purchase consideration is agreed and the date of giving effect to the transfer are automatically adjusted in the bank and cash balances.

An account must now be opened in the company's books for each asset and liability, and for the vendor. To the Vendor's Account will be credited the assets, and debited the liabilities taken over and the discharge of the purchase price.

Illustrations. (1) *A company was formed to acquire the business of X. The Balance Sheet of the latter at the date of acquisition was as follows—*

X's B/S.

	£			£
Capital	11,950	*Land and Buildings*		8,000
Creditors	5,900	*Furniture and Fittings*		200
Bank Overdraft	1,500	*Stock*		5,000
		Debtors	6,000	
		Less *Reserve for Doubtful Debts*	300	
				5,700
		Prepayments		400
		Cash in Hand		50
	£19,350			£19,350

The assets and liabilities were taken over at the values above shown, and the price agreed upon was £13,000. *Show the opening entries in the company's books, the consideration being satisfied as to* £10,000 *in shares,* £1,000 *in cash, and the balance left on Loan Account at* 5 *per cent.*

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		£	£
	Sundries . . . . . . *Dr.*		
	To Sundries		
	Land and Buildings	8,000	
	Furniture and Fittings	200	
	Stock	5,000	
	Debtors	6,000	
	Prepayments	400	
	Cash	50	
	Goodwill	1,050	
	Creditors		5,900
	Reserve for Doubtful Debts . .		300
	Bank		1,500
	Vendor		13,000
		£20,700	£20,700
	Assets and liabilities taken over on acquisition of the business of X as per agreement and minute of this date.		
	Vendor . . . . . . *Dr.*	13,000	
	To Share Capital Account . .		10,000
	,, Cash		1,000
	,, X, Loan Account at 5% . .		2,000
	Discharge of purchase consideration per agreement and minute of this date.		

LEDGER

VENDOR'S ACCOUNT

	£		£
To Creditors . . .	5,900	By Land and Buildings	8,000
,, Reserve for Doubtful Debts . . .	300	,, Furniture and Fittings . .	200
,, Bank . . .	1,500	,, Stock . . .	5,000
,, Share Capital Account . . .	10,000	,, Debtors . .	6,000
,, Cash . . .	1,000	,, Prepayments. .	400
,, Loan Account .	2,000	,, Cash . . .	50
		,, Goodwill . .	1,050
	£20,700		£20,700

It has not been thought necessary to reproduce the remaining Ledger accounts.

(2) *The summarized Balance Sheet of Y was as follows—*

	£		£
Capital . . .	5,430	*Sundry Assets* . .	7,900
Creditors . . .	2,470		

A company was formed to take over the business. The assets were revalued at £7,000 (excluding Goodwill), and it was agreed that the purchase price be £4,400, to be satisfied in shares. Show the Vendor's Account in the company's books.

VENDOR'S ACCOUNT

	£		£
To Creditors . .	2,470	By Sundry Assets .	7,000
„ Share Capital Account . .	4,400		
„ Capital Reserve .	130		
	£7,000		£7,000

PROFITS PRIOR TO INCORPORATION

The most convenient date for taking over a business is usually the date to which a Balance Sheet is prepared. It is therefore not uncommon to find that a company is incorporated to take over a business as from the date of the last Balance Sheet, which date is prior to the date of the company's being incorporated. Since the company does not exist until it is incorporated, the peculiar position arises that a non-existing person has been assumed to carry on business.

In fact, however, the company takes over the assets and liabilities as they exist on the date of incorporation; anything done in the meantime has merely gone to increase or diminish the assets which were there at date of the Balance Sheet by

reference to which the purchase consideration was fixed. Any profits or losses made in the intervening period are therefore not profits or losses made or incurred by the company, but are of a capital nature, as should readily be seen from the following illustration.

Illustration. *A company was incorporated on 1st June to take over a business as from the previous 1st April. Balance Sheets drawn up on the respective dates were as follows—*

	1st April	1st June		1st April	1st June
	£	£		£	£
Capital	18,000	18,000	*Premises*	13,100	13,100
Creditors	6,000	5,400	*Furniture, etc.*	600	600
Profits		700	*Stock*	3,000	2,700
			Debtors	4,900	5,600
			Bank Balance	2,400	2,100
	£24,000	£24,100		£24,000	£24,100

The purchase price was agreed at the amount of the capital, £18,000. Show the Journal entries for opening the company's books on the 1st June.

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	£	£
Sundries . . . . . . *Dr.*		
To Sundries		
Premises	13,100	
Furniture, etc.	600	
Stock	2,700	
Debtors	5,600	
Bank	2,100	
Creditors		5,400
Vendor		18,000
Capital Reserve		700
	£24,100	£24,100
Sundry assets and liabilities taken over on acquisition of the business of Y, per agreement and minute of this date.		

It will be seen from the above illustration that the profit prior to the date of incorporation is clearly capital in the hands of the company. Similarly, a loss would merely go to increase the price in fact paid for goodwill.

In practice, however, it is rarely convenient to take out a special Balance Sheet at the date of incorporation, owing to the incommensurate trouble and expense, e.g. of stocktaking. Accordingly, the accounts are carried to the usual accounting date, and it is then necessary to apportion the profits equitably between the periods prior and subsequent to the date of incorporation.

If the turnover were spread evenly month by month throughout the year, the apportionment could be made on a "time" basis, that fraction of the year's profits that the number of months prior to incorporation bears to the year being treated as earned prior. It would, however, be most unlikely that profits were earned so evenly, and such a method would normally be most inequitable.

Again, to apportion on the basis of the proportion that the turnover of the period prior to incorporation bears to the whole year's turnover would ignore the fact that most of the "standing" charges, e.g. rent, rates, insurance, salaries, office expenses, depreciation, etc., are incurred irrespective of turnover.

Whatever method is adopted, there must be treated separately those expenses which are solely attributable to one period only, e.g. directors' fees.

To meet the situation, it is preferable that the gross profit (which naturally is directly attributable to turnover) be apportioned on the basis of

sales for the respective periods, but that all items appearing in the Profit and Loss Account be apportioned according to their respective merits, those that vary with turnover being apportioned on a sales basis, those which do not on a time basis.

Illustration. *Parasols Ltd. was incorporated on* 1st *August,* 1937, *for the purpose of taking over as a going concern the business of sunshade manufacturers carried on by Y. Brolly and O. Gamp. The purchase price was determined on the basis of a Balance Sheet drawn up as on* 1st *February,* 1937, *and the vending agreement provided that the Vendors should be entitled to* 50 *per cent of the profits earned prior to incorporation in lieu of interest on the unpaid purchase money.*

Accounts were prepared for the year to 1st *February,* 1938, *the summarized trading results being as follows—*

	£		£
Materials consumed	19,000	*Sales* less *Returns*	34,000
Manufacturing Wages	5,000		
Gross Profit c/d	10,000		
	£34,000		£34,000
General Expenses	6,100	*Gross Profit b/d*	10,000
Net Profit	3,900		
	£10,000		£10,000

Further inquiry shows that—

(1) *The General expenses include directors' fees of* £250 *and Formation expenses* £300.

(2) *Sales to the value of* £11,000 *were made during the first six months of the trading period.*

You are required to prepare a statement showing the profits earned prior to and since incorporation

and the proportion thereof due to the Vendors, and to state how the company may deal with the profits earned in the respective periods.

(Ignore income-tax.)

STATEMENT OF PROFITS EARNED PRIOR TO AND SINCE INCORPORATION

	Prior to Incorporation	Since Incorporation		Prior to Incorporation	Since Incorporation
	£	£		£	£
To Directors' Fees		250	By Gross Profit—		
„ Formation Expenses		300	Prior to Incorporation, 11,000/34,000ths		
„ General Expenses	2,775	2 775			
„ Net Profit	460	3,410	of £10,000	3,235	
			Since Incorporation, 23,000/34,000ths of £10,000		6,765
	£3,235	£6,765		£3,235	£6,765

Profits due to Vendors 50 per cent of £460 = £230.

Note. The gross profit varies with the turnover and has been apportioned accordingly. In the absence of information as to any general expenses which may vary with turnover, it has been assumed that they are constant, and apportionable on a "time" basis.

The profits earned prior to incorporation should be taken to a capital reserve or used to write down goodwill or other assets. Those earned since incorporation are available for dividend.

Illustration. *By an agreement dated* 31*st March, A and B transferred their business as from* 1*st January to a private company, A and B Ltd., which had been incorporated on* 28*th February.*

On 1*st April A and B were appointed directors, they were each allotted and each paid in full for* 500 *shares of* £1 *each, and the company paid Preliminary Expenses amounting to* £300.

On 30*th April the company paid the purchase consideration of* £10,000 *together with interest at* 6 *per cent per annum from the date of the agreement*

as provided therein. On the same date 4,500 shares each were allotted to A and B and paid for by them.

The profits for the year ended 31st December amounted to £1,000 before charging interest on the purchase price or directors' fees which had been fixed at £300 per annum each.

Show by Journal entries how the above transactions should be recorded in the company's books including the relevant closing entries as on 31st December. Income-tax can be taken as 4s. 6d. in the £.

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		£	s	d	£	s.	d.
Mar. 31	Sundry Assets (net) . . *Dr.*	10,000	0	0			
	To A & B				10,000	0	0
	Sundry net assets acquired per agreement of this day, as from 1st January.						
Apr. 1	Cash . . . . . *Dr.*	1,000	0	0			
	To Share Capital Account .				1,000	0	0
	Allotment of 500 shares of £1 each to A and to B, paid for in full in cash.						
	Preliminary Expenses Acct. *Dr.*	300	0	0			
	To Cash				300	0	0
	Discharge of expenses.						
Apr. 30	Interest on Purchase Consideration Account . . *Dr.*	50	0	0			
	To A and B . . .				50	0	0
	Interest at 6% per annum on £10,000 purchase consideration from 31st March to 30th April—one month.						
	A and B . . . . *Dr.*	11	5	0			
	To Income-tax Account .				11	5	0
	Income-tax at 4s. 6d. in £ on Interest as above.						

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		£	s.	d.	£	s.	d.
	A and B . . . . . *Dr* To Cash . . . . Discharge of purchase consideration and interest.	10,038	15	0	10,038	15	0
	Cash . . . . . *Dr* To Share Capital Account . Allotment of 4500 shares of £1 each to A and to B, paid for in full in cash	9,000	0	0	9,000	0	0
Dec. 31	Profit and Loss Account . *Dr.* To Directors' Fees . . Directors' Fees of £300 per annum each to A and B for the nine months to date.	450	0	0	450	0	0
	Profit and Loss Account . *Dr* To Interest on Purchase Consideration . . . Transfer of Interest.	50	0	0	50	0	0
	Profit and Loss Account . *Dr.* To Capital Reserve (Profits prior to Incorporation) . Profits for the two months to 28th February, prior to incorporation, transferred.	166	13	4	166	13	4

Note. On the information given, it is not possible to make an accurate estimate of the profits prior to incorporation. Since the turnover is rarely distributed evenly throughout the year, a "time" basis for the apportionment of the profit, such as that adopted above, is not equitable. The gross profit and items varying with turnover should be apportioned between the periods prior and subsequent to incorporation on the basis of turnover, standing charges on the basis of time and other items according to their nature, e.g. directors' fees should be charged wholly against the period subsequent to incorporation. In the absence of the relevant details, however, a "time" basis has had to be adopted.

The relevant date for the apportionment is the date of incorporation, not the date of the agreement.

Illustration. *A company was incorporated on 1st May to take over a business from the preceding 1st January. The amounts were made up to 31st December as usual. The Trading and Profit and Loss Account for the year gave the following result.*

	£		£
To Stock, 1st January .	14,000	*By Sales* . . .	120,000
,, *Purchases* less *Returns*	91,000	,, *Stock, 31st December*.	15,000
,, *Gross Profit c/d* .	30,000		
	£135,000		£135,000
To Rent, Rates, and Insurance . .	1,800	*By Gross Profit b/d* .	30,000
,, *Directors' fees* . .	2,000		
,, *Salaries* . . .	5,000		
,, *Office Expenses* .	5,000		
,, *Travellers' Commission*	300		
,, *Carriage Outwards* .	800		
,, *Discounts* . .	1,500		
,, *Bad Debts* . .	200		
,, *Audit fee* . .	250		
,, *Depreciation* . .	600		
,, *Debenture Interest, 8 months* . . .	450		
,, *Interest on Purchase consideration to date of completion, 31st August* . . .	1,600		
,, *Net Profit* . .	10,500		
	£30,000		£30,000

It is ascertained that the sales for January, March, and September are one and a half times the average of those for the year, whilst those for December are twice the average, and those for February only half the average. Apportion the profits to the nearest £.

Apportionment of Profits. If the average sales per month are taken as one point, the monthly sales must be as follows—

An average of 1 point per month gives 12 points for the year.

5 months' account for 7 points, hence the remaining 7 months total 5 points, i.e. $\frac{5}{7}$ths per month.

	Points	Points	
January .	$1\frac{1}{2}$	$1\frac{1}{2}$	
February .	$\frac{1}{2}$	$\frac{1}{2}$	$4\frac{3}{14}$
March . .	$1\frac{1}{2}$	$1\frac{1}{2}$	
April . .		$\frac{5}{7}$	
May . .		$\frac{5}{7}$	
June . .		$\frac{5}{7}$	
July . .		$\frac{5}{7}$	
August . .		$\frac{5}{7}$	
September .	$1\frac{1}{2}$	$1\frac{1}{2}$	$7\frac{11}{14}$
October .		$\frac{5}{7}$	
November .		$\frac{5}{7}$	
December .	2	2	
	7	12	

The turnover is therefore in the ratio of 59 : 109.

PROFIT AND LOSS APPORTIONMENT ACCOUNT

	Prior	Subsequent		Prior	Subsequent
	£	£		£	£
To Rent, Rates, and Insurance (4 : 8) .	600	1,200	By Gross Profit (59 : 109)	10,536	19,464
„ Directors Fees . .		2,000			
„ Salaries (4 : 8) . .	1,667	3,333			
„ Office Expenses (4 : 8)	1,667	3,333			
„ Travellers' Commission (59 : 109) .	105	195			
„ Carriage Outwards (59 : 109) . .	281	519			
„ Discounts (59 : 109) .	527	973			
„ Bad Debts (4 : 8) .	67	133			
„ Audit fee (4 : 8) .	83	167			
„ Depreciation (4 : 8) .	200	400			
„ Debenture Interest .		450			
„ Interest on purchase consideration (4 : 4).	800	800			
„ Net Profit to Capital Reserve . . .	4,539				
„ Net Profit to Appropriation Account .		5,961			
	£10,536	£19,464		£10,536	£19,464

Notes. Rent, etc.; Salaries; Office Expenses; Audit Fee and Depreciation are standing charges unaffected by turnover, and apportionable on a "time" basis, i.e. four months proportion prior to incorporation.

Directors' fees and debenture interest are charges wholly incurred after incorporation.

Travellers' Commissions and Discounts strictly apply to the turnover of the periods in which the sales were made on which they are computed. In the absence of information as to such sales, however, the turnover of the period under review has to be taken.

Carriage outwards is on the sales, and apportionable accordingly.

Bad Debts would normally be charged to the period in which they were written off. Where this is not identified, a time basis is more correct than a turnover basis, since they are not related to turnover directly, but are rather a risk of the year.

Interest on purchase consideration must be apportioned on an accruals basis, i.e. four months prior and four months subsequent to incorporation.

In practice, many of the amounts could be ascertained exactly without apportionment, but it is not always considered worth while to do so.

It is necessary to remark that the date of the certificate entitling a public company to commence business does not in any way affect the question. The sole reason for the apportionment is that the company cannot make profits before it comes into existence; profits made thereafter can be taken credit for, irrespective of the legal formality of getting a "trading" certificate.

If there is a Goodwill Account in existence, the profit prior to incorporation can be credited thereto, instead of being shown separately as a capital reserve. Even where goodwill has been expressly valued, it is still correct to charge a loss prior to incorporation as an addition to that asset, since the loss is in effect an addition to the real purchase price, but in many cases the loss will be written off against profits made since incorporation, and as soon as possible.

A further illustration of apportionment of profits prior to incorporation will be found in Chapter XII.

STATUTORY REPORT (PUBLIC COMPANIES)

By Section 113, Companies Act, 1929, every company limited by shares and every company limited by guarantee and having a share capital must, within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of its members, which is called the statutory meeting. At least seven days before the date of the meeting, the directors must forward a report (called the Statutory Report) to every member of the company, and file a copy forthwith with the Registrar of Companies. The report must, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors (if any) of the company. The whole report must be certified by not less than two directors, or, where there are less than two directors, by the sole director and manager.

The following illustration of a report shows the information which it must contain.

Illustrations. (1) *The following information relates to a new public company—*

Receipts. From allotment of 100,000 *Ordinary Shares of* £1 *each,* £93,000; *from allotment of* 200,000 *Preference Shares of* 10s. *each, issued as paid up to the extent of* 5s. *per share in consideration of vending of old business,* £50,000; *Mortgage on*

Premises, £40,000; Trading Receipts, £30,000; Sale of Investments, £9,000; Loan from Bank, £50,000.

Payments. Purchase of Freehold Buildings, £75,000; Purchase of Machinery, £6,000; Preliminary Expenses paid on account, £2,500; Purchase of Investments, £160,000; Trading Payments, £7,000.

Owing. Balance of Preliminary Expenses, £450.

You are required to prepare a Statutory Report (with the exception of particulars of Directors and other officers, but with necessary certificates), and to state the requirements of the Companies Act in relation to Statutory Meetings.

STATUTORY REPORT

Report pursuant to Section 113 of the Companies Act, 1929, of the New Public Co. Ltd.

(*a*) The total number of shares allotted is 100,000 Ordinary Shares of £1 each and 200,000 Preference Shares of 10s. each, of which 200,000 Preference Shares are allotted as paid up to the extent of 5s. per share in consideration of the purchase of the business of X & Co., and upon each of the Ordinary Shares the sum of £1 is payable in cash, and upon each of the Preference Shares the sum of 5s. is so payable. On 14,000 Ordinary Shares, the sum of 10s. per share has been received to date; the remainder are fully paid up.

(*b*) The total amount of cash received by the company in respect of the shares allotted wholly for cash is £93,000, and on the shares allotted partly for cash is £50,000.

(*c*) The Receipts and Payments of the company to the day of 19 , are as follows—

Particulars of Receipts	£	*Particulars of Payments*	£
Amount received on 100,000 Ord. Shares issued for Cash	93,000	Purchase of Freehold Buildings	75,000
Amount received on 200,000 Pref. Shares issued partly for cash	50,000	Purchase of Machinery	6,000
Amount received on Mortgage on Premises	40,000	Preliminary Expenses paid on Account	2,500
Amount received from Sale of Investments	9,000	Purchase of Investments	160,000
Trading Receipts	30,000	Trading Expenses	7,000
Loan from Bank	50,000	Balance at —— Bank	21,500
	£272,000		£272,000

The following is an account of the Preliminary Expenses of the Company—

Cost of Registration of the Company, Underwriting Commission, Law Costs, Brokerage, Printing and Advertising, etc. . . . £2,950

Particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

We hereby certify this report.

Two Directors.

We hereby certify that so much of this Report as relates to the shares allotted by the Company, and to the Cash received in respect of such shares and to the receipts and payments of the Company on Capital Account, is correct.

Auditors.

Every company limited by shares, and every company limited by guarantee and having a share capital, except private companies, must within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company which is called "the statutory meeting."

The directors must, at least seven days before the day on which the meeting is held, forward a report (referred to as "the statutory report") to every member of the company.

The directors must cause a copy of the statutory report, certified as required by this section, to be delivered to the Registrar of Companies for registration forthwith after sending it to the members of the company.

The directors must cause a list showing the names, descriptions, and addresses of the members of the company, and the number of shares held by them respectively, to be produced at the commencement of the meeting, and to remain open and accessible to any member of the company during the continuance of the meeting.

The members of the company present at the meeting are at liberty to discuss any matter relating to the formation of the company, or arising out of the statutory report, whether

previous notice has been given or not, but no resolution of which notice has not been given in accordance with the Articles may be passed.

The meeting may adjourn from time to time, and at any adjourned meeting any resolution of which notice has been given in accordance with the Articles, either before or subsequently to the former meeting, may be passed, and the adjourned meeting has the same powers as an original meeting.

In the event of any default in complying with the above provisions every director of the company who is guilty of or who knowingly and wilfully authorizes or permits the default is liable to a fine not exceeding fifty pounds. (S. 113.)

If the statutory meeting is not held or the statutory report is not filed, a shareholder may present a petition for the winding-up of the company after the expiration of fourteen days from the last day on which the meeting ought to have been held. (Ss. 168 (2) and 170.) Instead of making a winding-up order, however, the Court may direct the statutory report to be filed or the statutory meeting to be held. (S. 170 (2).)

A contract referred to in the prospectus or statement in lieu of prospectus may not be varied prior to the statutory meeting, except subject to the approval of such meeting. (S. 36.)

(2) *Black and White decided to form a limited company for the purpose of manufacturing textiles. To finance operations they opened a joint bank account into which Black paid £300 and White £200. They received £250 from A and £100 from B, as payments in full for shares to be allotted in the proposed new company and both these amounts were paid into the joint account.*

The following is a summary of the payments made out of the joint account—

	£		£
Travelling Expenses	45	*Wages—*	
Machinery purchased	230	*Cleaning up premises*	25
Postages and Sundry Expenses	10	*Overhauling Boiler and shafting*	36
Deposit on purchase of Factory for £2,000	200	*Solicitor, on account of costs of forming the Company*	150

A limited company, under the style of B. and W. Textiles Ltd., was formed with an Authorized Capital of £25,000 in Ordinary Shares.

Black and White sold to the company certain secret processes for £2,000, payable in shares, and, pursuant to the agreement, 1,000 shares were allotted to each of them as fully paid.

The company took over the contract relating to the purchase of the factory and the vendor accepted three promissory notes of £600 each, due at intervals of six months, for the balance. The costs of acquisition were £35 and were paid.

Black and White sold to the company the machinery they had purchased for £346, this figure including the sundry disbursements made by them, and the company agreed to reimburse them for the payment to the Solicitor.

The balance of the joint account was transferred to the company and Black and White were allotted fully-paid shares for the amounts due to them. The shares due to A and B were also allotted.

Applications for 10,000 shares were received accompanied by a payment of 5s. per share. These were allotted and a further 5s. per share was paid on allotment.

The company accepted the offer of JK, a machinery maker, to supply £2,000 worth of machinery on the terms that £1,000 should be paid in cash and £1,200 placed to his credit on loan at 5 per cent interest.

Machinery to the value of £500 had been delivered and a pro rata payment made to him.

A dispute arose with GH in connexion with the water rights, and, after incurring costs amounting to

£15 in contesting his claim, the company agreed to pay him £200 in settlement thereof.

These amounts were paid.

You are required to show—

(a) The Cash Book and Ledger entries to record the foregoing transactions in the books of the company.

(b) How the information given should appear in the Statutory Report.

CASH BOOK

	£		£
To Black and White	154	By Factory Account Costs	35
„ Application and Allotment Account—		„ JK	250
Application Money, 5s. a share on 10,000 shares	2,500	„ GH—Settlement of dispute *re* Water Rights	200
Allotment Money, 5s. a share on 10,000 shares	2,500	„ Costs	15
		„ Balance c/d	4,654
	£5,154		£5,154
To Balance b/d	4,654		

BLACK & WHITE

	£		£
To Share Capital Account – Shares allotted as fully paid.		By Machinery Account	346
A	250	„ Preliminary Expenses Account—Solicitors' Costs	150
B	100	„ Factory Account—Deposit	200
Black	300	„ Cash	154
White	200		
	£850		£850
To Share Capital Account	£2 000	By Secret Processes Account	£2,000

FACTORY ACCOUNT

	£		
To Black and White—Deposit	200		
„ Vendor's Account	1,800		
„ Cash—Costs	35		
	£2,035		

PROMISSORY NOTES ACCOUNT

			£
		By Factory Account	1,800

SHARE CAPITAL ACCOUNT

			£
		By Black and White—fully paid	2,850
		„ Application and Allotment Account, 10s. paid	5,000
			£7,850

VENDOR'S ACCOUNT (FACTORY)

	£		£
To Promissory Notes Payable Account, Three Notes of £600 due at intervals of six months	1,800	By Factory Account	1,800

APPLICATION AND ALLOTMENT ACCOUNT

	£		£
To Share Capital Account	5000	By Cash—Applications for 10,000 Shares, 5s. per Share now paid	2,500
		„ Cash—Allotment Money, 5s. per Share on 10,000 Shares	2,500
	£5,000		£5,000

MACHINERY ACCOUNT

	£		
To Black and White	346		
„ JK	550		
	£896		

SECRET PROCESSES ACCOUNT

	£		
To Black and White	2,000		

JK

	£		£
To Cash	250	By Machinery Account	550
„ Balance c/d	300		
	£550		£550
		By Balance b/d carrying interest at 5%	300

Note. It would appear that the excess of the full purchase price over the nominal value of the machinery is an addition to the purchase price, and it has been so treated.

PRELIMINARY EXPENSES

	£		
To Black and White . .	150		
„ Cash—Costs and agreed sum in settlement of dispute *re* Water Rights	215		

EXTRACTS FROM STATUTORY REPORT

The total number of shares allotted is 12,850 ordinary shares of £1 each, of which 2,000 shares have been allotted as fully-paid as consideration for the purchase of secret processes, upon each of 850 shares the sum of £1 has been paid in cash, and upon each of the remaining 10,000 shares the sum of 10s. has been paid in cash.

The total amount of cash received by the company in respect of the shares issued wholly for cash is £5,850.

The Receipts and Payments of the company to ... ... are as follows—

Particulars of Receipts	£	*Particulars of Payments*	£
To Amount Received on Application and Allotment of 10,850 Shares	5,850	By Preliminary Expenses . .	365
		„ Deposit on Factory . .	200
		„ Costs	35
		„ Machinery	596
		„ Balance at Bank . .	4,654
	£5,850		£5,850

The following is an Account (or Estimate) of the Preliminary Expenses of the Company—

Estimated at (say) £500

Here follow the names, addresses and descriptions of the directors, auditors, managers, and secretary of the company, and particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

We hereby certify this Report.

} *Directors.*

We hereby certify that so much of this Report as relates to the shares allotted by the Company and to the cash received in respect of such shares and to the receipts and payments of the company on Capital Account is correct.

(*Signed*)

Chartered Accountants.

Auditors.

Dated . . ..

Notes. (1) The reimbursement of Black and White and the contra transactions with them amount to their paying for 500 shares in cash.

(2) The amount paid in settlement of the claim with regard to Water Rights has been treated as preliminary expenses, although it might more correctly, according to the facts of the case, be regarded as part of the cost of the factory.

If this settlement involves a modification of a contract into which the Company has entered, particulars of such modification should be included in the appropriate section of the Statutory Report.

CHAPTER V

LOAN CAPITAL

BORROWING—Debentures—Mortgages

THE issued share capital of a company is a fixed fund, and, whilst there is little difficulty, from the legal viewpoint at least, in increasing it, there are, as has already been seen, costly and complicated legal processes involved in a reduction. Moreover, where money has to be raised, the dividends expected on share capital must be at higher rates than the interest payable on borrowed money, since there is a greater risk of loss of capital on shares than on loans, etc. It is frequently found, therefore, that companies raise money by borrowing, since, if the funds become available, the liability so created can, subject to the terms of issue, be repaid.

The borrowing may take the form of a loan with or without security, e.g. a bank overdraft, a mortgage on property, an issue of debentures, or making and discounting bills of exchange or promissory notes.

A company has implied power to borrow if properly incident to the course and conduct of its proper business, e.g. a trading or banking company; any other company can only borrow if so authorized by its Memorandum of Association. If a limit is placed upon the borrowing powers, that limit must not be exceeded. Any limitation so placed upon borrowing is better stated in the Articles, since it can be more easily altered when

required. In some cases companies which have exceeded their borrowing powers have purchased goods and/or services on credit, paying in bonds (commonly called "Lloyd's Bonds" after their originator), which can be negotiated.

It is not within the scope of this work to explore the legal aspects of excessive borrowing, or the remedies of the lenders, and in the remarks that follow, it must be presumed that the directors are working within their powers.

A company can borrow in any of the ways that an individual can employ, and it is not necessary to explain the records involved in the case of bank loans or overdrafts, bills of exchange, etc.

DEBENTURES

Where there is some measure of permanence in the loan, the most common mode is on debentures. A debenture is a document evidencing a debt, and is usually given under the seal of the company. Debentures might be "naked," i.e. without giving any security, but usually they charge the property of the company in some way with the payment.

On the issue of debentures, the terms usually provide for a deposit on application, a further instalment on allotment, and the balance by stated instalments on named dates. The entries in the books of account are similar to those on an issue of shares, except that "instalment accounts" take the place of call accounts. In every case, the debentures must appear at their nominal amount in the Balance Sheet, any discount or premium being separately shown.

Illustration. *C Ltd. made an issue, which was*

fully subscribed, of £200,000 4 per cent First Mortgage Debenture Stock at 98 per cent.

The lists opened and closed and the stock was allotted on 31st July, subscriptions being payable 10 per cent on application, 40 per cent on allotment, 25 per cent on 1st September, and 23 per cent on 31st December.

Under the terms of the issue, payment could be made in full on 1st September, interest on any amounts prepaid being allowable at the rate of 1½ per cent per annum; such interest was not deductible from the subscriber's payment, but was payable by the company on 31st December.

The allottees of one-half of the stock took advantage of the prepayment terms. The others paid on the due dates.

Journalize the entries to be made in the company's books. Ignore income-tax.

JOURNAL

		£	£
19.. July 31	Cash . . . . . . *Dr.*	20,000	
	To Application and Allotment Account		20,000
	Cash received on application on £200,000 4% First Mortgage Debenture Stock.		
	Application and Allotment Account *Dr.*	100,000	
	To 4% First Mortgage Debenture Stock Account		100,000
	10% due on application and 40% on allotment on £200,000 Stock allotted this day.		
	Cash . . . . . . *Dr.*	80,000	
	To Application and Allotment Account		80,000
	Cash received on allotment.		

JOURNAL—(*contd.*)

		£	£
	Discount on Issue of Debentures Account . . . . . *Dr.*	4,000	
	To 4% First Mortgage Debenture Stock Account		4,000
	Discount of 2% on the issue of £200,000 as per terms of issue.		
Sept. 1	First Instalment Account . . *Dr.*	50,000	
	To 4% First Mortgage Debenture Stock Account		50,000
	Instalment of 25% due this day.		
	Cash . . . . . . *Dr.*	73,000	
	To First Instalment Account . .		50,000
	„ Second Instalment Account .		23,000
	Cash received on first instalment and payment in advance in respect of second instalment.		
Dec 31	Second Instalment Account . *Dr.*	46,000	
	To 4% First Mortgage Debentures Account		46,000
	Instalment of 23% due this day.		
	Cash . . . . . . *Dr.*	23,000	
	To Second Instalment Account .		23,000
	Balance of cash received on second instalment.		
	Interest on Instalment paid in Advance Account . . . . *Dr.*	115	
	To Cash		115
	Interest at 1½% per annum on £23,000 for 4 months.		

Note. In practice the cash would not be journalized.

In many cases, debentures are issued to bankers as additional security for a loan or overdraft. Such debentures must not be credited to the Debentures Account, as they only become definite liabilities in the event of the company defaulting on the loan or overdraft. In the meantime, the debentures are contingent liabilities, and will be shown on the company's Balance Sheet as a note under the loan or overdraft in respect of which they have been issued.

Some accountants debit a Debenture Suspense Account and credit Debentures Account on such an issue, the two items being treated as contra entries, and shown in the Balance Sheet as already described. This method is not recommended.

It is of interest to note that Section 75 of the Companies Act, 1929, provides that debentures so issued shall not be considered to have been redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remain deposited. Accordingly, in such circumstances, a note should still appear on the Balance Sheet, although there is no liability.

Such debentures do not, of course, carry interest.

Where they will command it, debentures may be issued at a premium, in the same way that shares can be so issued. In many cases, however, debentures are issued at a discount. It will be remembered that shares cannot be so issued, except with the sanction of the Court under Section 47 of the Companies Act, 1929 (see Chapter III). The state of the market and the status of the company determine the price of issue, and students should realize the real effect of an issue at a premium or discount.

To take an example, let it be supposed that a company requires the sum of approximately £40,000, which it determines to borrow on debentures. The rate of interest that the company is prepared to pay is 4 per cent, and the term of the debentures is twenty years.

Looking at the position broadly, i.e. ignoring income-tax and the actuarial calculations required to arrive at exact results, it will be seen that if

the credit of the company is such that an issue at par would be successful at less than $3\frac{3}{4}$ per cent, the company by agreeing to pay 4 per cent can command a premium on the issue. This is clearly shown by the following figures—

If the company issues debentures for £40,000 at a premium of 3 per cent the actual sum raised is £41,200.

	£
On this the company will pay interest for the 20 years amounting to 4% on £40,000 × 20	32,000
And will repay at the end of the 20 years the nominal value	40,000
Total paid by company	72,000
Deduct Sum borrowed	41,200
Cost to company over 20 years. . . .	£30,800

This amount, £1,520 per annum, is equivalent to approximately 3·7 per cent on the sum the company has had the use of for the period.

The only real reason for a first issue at a premium in such a case, however, is where it would be impossible to arrive at a practicable rate of interest on a par basis. In the case of a further issue where debentures already exist, an issue at a premium may be a practical necessity because existing debentures stand in the market at a premium, and it may not be desirable to make the new issue at a lower rate of interest.

Illustration. *A company with an outstanding issue of* £50,000 5 *per cent debentures, standing in the market at* 110, *decides to issue a further* £20,000 *debentures* (*irredeemable*).

Since the yield on the existing debentures is $\frac{5 \times 100}{110} = 4{\cdot}5\dot{4}\dot{5}$ per cent, the company could

expect a successful issue at such a percentage. It is not practicable, however, to adopt such a percentage, and the company would therefore offer the debentures as carrying 5 per cent interest, at a premium of 10 per cent; or might decide to offer $4\frac{1}{2}$ per cent interest, making the issue at a discount of 1 per cent.

It should be appreciated from the above remarks that the premium is in effect a reduction in the interest payable, since the rate of interest is calculated on the nominal value, not on the higher amount actually borrowed. Where there is no sinking fund created, the interest can be written off to the credit of Profit and Loss Account in proportion to the debentures outstanding in each accounting period, thus giving a net charge to Profit and Loss Account of the real effective interest rate. Where a sinking fund is to be created, the premium can be used as its nucleus.

An issue at a discount has the effect of the company paying a higher effective rate of interest than that normally payable.

Illustration. *A company wishes to raise approximately £40,000 by an issue of debentures, and is prepared to pay 4 per cent, and to repay in twenty years. It is found that the market rate for such an issue is approximately $4\frac{1}{4}$ per cent. It will therefore be necessary to make the issue at a discount.*

Ignoring actuarial calculations and income-tax, the position can be shown thus—

If the company issues debentures for £40,000 at a discount of $2\frac{1}{2}$ per cent, the actual sum raised will be £39,000.

On this the company will pay interest for the 20 years amounting to 4% on £40,000 × 20	32,000
And will repay at the end of the 20 years the nominal value	40,000
Total paid by the company	72,000
Deduct Sum borrowed	39,000
Cost to company over 20 years . .	£33,000

This amount, £1,650 per annum, is equivalent to approximately 4·23 per cent on the sum the company has had the use of for the period.

It is not thought necessary to go into the actuarial calculations here; the "straight" calculations above show the principle involved.

DEBENTURE DISCOUNT

It will be seen that the discount is in effect deferred interest, and that it should therefore be written off over the lifetime of the debentures, unless there is a sinking fund. The writing off should be in proportion to the amount of debentures outstanding for the year.

It may be found expedient in some cases to issue at par, and provide for a premium on redemption; this has the same effect as an original issue at a discount.

Illustration. *To raise £40,000, a company makes an issue of £40,000 debentures, carrying interest, at 4 per cent, and repayable at a premium of 2½ per cent in twenty years.*

The real interest is therefore 4 per cent plus one-twentieth of 2½ per cent, i.e. 4⅛ per cent.

Many other terms of issue may be met in practice, e.g. provision for purchase by the company in the open market; for redemption on a given date

at par or at (say) 101, but if redeemed by the company at an earlier date, at (say) 102, etc.

Illustrations of writing off debenture discount will now be given, where there is no sinking fund.

Illustration. (1) *An issue of debentures amounting to £45,000 nominal was made at a discount of 2 per cent, repayable over ten years at par, by equal annual instalments.*

The discount should be written off as follows—

Year	Amount of Debentures Outstanding for Year	Ratio	Proportion Written Off	Amount		
	£			£	s.	d.
1	45,000	10	$\frac{10}{55}$	163	12	9
2	40,500	9	$\frac{9}{55}$	147	5	6
3	36,000	8	$\frac{8}{55}$	130	18	2
4	31,500	7	$\frac{7}{55}$	114	10	11
5	27,000	6	$\frac{6}{55}$	98	3	8
6	22,500	5	$\frac{5}{55}$	81	16	4
7	18,000	4	$\frac{4}{55}$	65	9	1
8	13,500	3	$\frac{3}{55}$	49	1	10
9	9,000	2	$\frac{2}{55}$	32	14	6
10	4,500	1	$\frac{1}{55}$	16	7	3
		55		£900	0	0

It will be seen that the first year, having the benefit of ten times as much of the money raised, ought to bear ten times as much of the discount as the last year; the second year nine times, and so on.

Illustration. (2) *An issue of £100,000 Debentures at 98 was to be repaid on the twentieth anniversary of the date of issue. Show how the discount should be written off.*

Since each year of the twenty has the benefit of the whole of the debentures, the discount,

£2,000, should be written off by equal annual instalments of £100.

Illustration. (3) *A company issued £200,000 in £100 Debentures to finance a series of contracts to be completed on specified dates, undertaking to refund the debentures on dates fixed to allow adequate margin of time to collect the contract prices. The issue took place, at 97½, on 1st June, 1932. The company's financial year ended on 31st December. The terms of issue provided for repayment on the following dates*—

31st December, 1935 . .	100 debentures
31st December, 1937 . .	300 ,,
30th June, . 1938 . .	200 ,,
30th June, . 1939 . .	500 ,,
31st December, 1942 . .	900 ,,

Show how the discount should be written off.

Year to 31st December	*Ratio = Average No. of Debentures Outstanding*	*Amount* £ s. d.
1932	1,000[1]	309 12 0
1933	2,000	619 3 11
1934	2,000	619 3 11
1935	2,000	619 3 10
1936	1,900	588 4 9
1937	1,900	588 4 8
1938	1,500[2]	464 7 11
1939	1,150[3]	356 0 9
1940	900	278 12 9
1941	900	278 12 9
1942	900	278 12 9
	16,150	£5,000 0 0

Where it is necessary to provide for a premium on repayments, this can be computed in precisely the same way as the provision for writing off discount.

[1] 2,000 for 6 months is equivalent to 1,000 for a year.
[2] 1,600 for 6 months and 1,400 for 6 months is equivalent to 1,500 for a year.
[3] 1,400 for 6 months and 900 for 6 months is equivalent to 1,150 for a year.

Students should bear in mind that the effect of writing off discount is to retain in the business cash which might otherwise be treated as available for dividend, since the balance of available profits is reduced thereby. This is readily seen from the following statements—

SUMMARIZED BALANCE SHEET IMMEDIATELY AFTER DEBENTURE ISSUE

	£		£
Capital	50,000	Sundry Assets	60,000
Debentures	40,000	Cash from Debenture issue	38,000
Creditors	10,000	Discount on do.	2,000
	£100,000		£100,000

SUMMARIZED BALANCE SHEET AFTER ACCUMULATED PROFITS

	£		£
Capital	50,000	Sundry Assets	60,000
Debentures	40,000	Asset purchased with proceeds of debenture issue	38,000
Creditors	10,000	Discount on Debentures	2,000
Profit and Loss Account	5,000	Cash	5,000
	£105,000		£105,000

If the discount be written off against profits, the balance on Profit and Loss Account is reduced to £3,000. If this is then distributed as dividend, there remains on the Balance Sheet £2,000 cash in place of the former £2,000 discount. Writing off the discount therefore provides out of profits the cash required to make up the amount which must be added to the actual cash borrowed to bring the latter amount up to the nominal amount repayable.

REDEEMABLE DEBENTURES

Debentures may be issued for any term, and it

is quite common for them to be made "irredeemable," i.e. only redeemable on a winding-up, or redeemable at the option of the company at any time after a named date. Where there is a discount, or a premium on redemption, to be provided in the latter case, provision can be made therefor over a reasonable period; preferably that period between the date of issue and the first available date for redemption.

In order to provide funds wherewith to redeem debentures, the company must either withhold profits from distribution or raise further moneys, either by an issue of shares or a loan. It might be possible to realize the assets for the acquisition of which the debentures were originally issued, but, except in the case of financing contracts, this would rarely be practicable.

If fresh capital is raised, the result is simply to substitute one class of "liability" for another, and an illustration is not necessary; the process is similar to the redemption of redeemable preference shares out of the proceeds of a fresh issue.

Where, however, profits are retained in the business, it is essential that students should realize exactly what happens. This can most readily be seen from the examination of a series of Balance Sheets.

Let it be supposed that a company requires the sum of £50,000 for the acquisition of fixed assets. Before raising this sum, its Balance Sheet is summarized as follows—

	£		£
Share Capital . .	100,000	Sundry Assets . .	110,000
Creditors . . .	10,000		

After issuing £50,000 debentures at par and buying the new assets, the Balance Sheet would read—

	£		£
Share Capital . . .	100,000	Sundry Assets . . .	110,000
Debentures . . .	50,000	New Assets . . .	50,000
Creditors . . .	10,000		

If from this date onwards the company were to distribute its profits "to the hilt" as they were earned, no change would appear in the Balance Sheet, except in the creditors and sundry assets, the changes in which would be complementary.

If, however, the company withheld profits from distribution each year, retaining the assets thus earned in a liquid form, so as to ensure that the cash required for repaying the debentures was available without disturbing the other assets, the Balance Sheet at the end of the period would read—

	£		£
Share Capital . . .	100,000	Sundry Assets . . .	110,000
Debentures . . .	50,000	"New" Assets[1] . .	50,000
Creditors . . .	10,000	Cash	50,000
Profit and Loss Account	50,000		

After the repayment of the debentures, the Balance Sheet would read—

	£		£
Share Capital . . .	100,000	Sundry Assets . . .	110,000
Creditors . . .	10,000	"New" Assets . . .	50,000
Profit and Loss Account	50,000		

It will be seen from this that the profits are still available for distribution, but they are now

[1] These are the assets purchased with the proceeds of the debenture issue, and for simplicity have not been depreciated.

represented by the assets purchased with the proceeds of the debenture issue. If these assets are required for use in the business, it would obviously cripple the business if a dividend were declared, as money would have to be borrowed to pay it. The effect is therefore that the assets have been bought out of profits, and to remove the temptation to declare dividends out of those profits, there should be transferred to Reserve an amount equal to the cash applied in redeeming the debentures, i.e. £50,000. This is still available for dividend if and when funds can be released for the payment; in the meantime the working capital is not vitiated.

In many cases, it may be found that there is no likelihood of such funds ever becoming available, but that the profits earned are high, and the company may then decide to capitalize the reserve and issue bonus shares, in order to bring its issued capital more into line with the permanent assets and working capital.

In the above example, it should be clear that moneys have been retained in the business in a liquid form, and accumulated over a period of years. Where this is done, there is a great temptation to employ this money in expansion of the business, with the result that when the time comes for repaying the debentures, it is found that the profits are locked up in stock, book debts, etc., which cannot readily be realized at the crucial moment.

To obviate this *impasse*, the money should be specifically "earmarked," by investment or otherwise, to ensure that it shall be available when required. A sinking fund is preferable, but before

dealing therewith, it is necessary to exemplify redemptions where no sinking fund is available.

The terms of issue of the debentures may provide for their all being redeemed at once, on a stated date, or by notice on or after a specified date, or by annual drawings. As already stated, provision may be made for redemption at a premium, or the company may be empowered to purchase in the open market for cancellation.

Where debentures are redeemed, either by drawings or by purchase or otherwise, any premium or discount on the redemption must be transferred to Reserve, and there must, as already explained, be transferred to Reserve, from Profit and Loss Account, an amount equal to the cash applied in redeeming the debentures. The balance on Reserve will then equal the nominal value of the debentures redeemed; obviously the correct figure, since it represents the assets acquired on the issue of the debentures.

Illustration. *A company had an outstanding liability on debentures amounting to* £45,000, *redeemable at the company's option by drawings at* 101 *per cent, or by purchase in the open market. The company had no Sinking Fund, but had an undistributed balance of profits amounting to* £19,000, *and decided to redeem* £15,000 *debentures. The directors were able to purchase* £10,000 *at* 100½ *per cent, expenses* £52, *and drew* £5,000 *debentures.*

Write up the above transactions in the books.

DEBENTURES ACCOUNT

	£		£
To Redemption Account . (1)	15,000	By Balance b/f	45,000
„ Balance c/d	30,000		
		By Balance b/d . . .	30,000

REDEMPTION OF DEBENTURES ACCOUNT

		£			£
To Cash . . .	(2)	10,102	By Debentures Account .	(1)	15,000
,, do.	(3)	5,050	,, Reserve Account	(4)	152
		£15,152			£15,152

RESERVE ACCOUNT

		£			£
To Redemption Account .	(4)	152	By Profit and Loss Account	(5)	15,152
,, Balance c/d		15,000			
			By Balance b/d . . .		15,000

It will be seen that the exact cost of the redemption is charged to the Redemption Account, the balance of which (4) represents the premium. This is debited to Reserve, which is credited with an amount equal to the cost of redemption, leaving a balance equal to the nominal value of the debentures redeemed.

Where the debentures have been issued at a discount, provision for the discount must be made according to the principles enunciated earlier in this chapter. If the redemption is by annual drawings, the amount of the discount can conveniently be charged to the Reserve Account, the balance on which will then equal the cash originally *raised* by the issue of the debentures now redeemed. If this method be not adopted, there will really be a double provision for the discount, since the cash applied in redemption not only repays the amount borrowed, but also pays the difference represented by the discount, and if the latter has already been debited to Profit and Loss Account, it is being debited indirectly a second time in the transfer to Reserve.

Many accountants prefer to transfer the whole of the discount to Reserve as soon as the latter has been credited with sufficient to cover it. This

is a matter of individual preference, but the latter treatment has much to be said for it.

Illustration. *On 1st January,* 1936, *a company issued* 220 5 *per cent* £100 *Debentures at* 99 *per cent, repayable by equal annual drawings over ten years.*

Show how the accounts would be affected for 1936 *and* 1937.

DEBENTURES ACCOUNT

1936		£	1936		£
Dec. 31	To Cash . . (2)	2,200	Jan. 1	By Sundries . (1)	22,000
1937					
Dec. 31	„ do. . . (5)	2,200			

DEBENTURE DISCOUNT ACCOUNT

1936		£	1936		£
Jan. 1	To Debentures Account (1)	220	Dec. 31	By Reserve Account (4)	40
			1937		
			Dec. 31	„ do. . . (7)	36

RESERVE ACCOUNT

1936		£	1936		£
Dec. 31	To Debenture Discount Account . (4)	40	Dec. 31	By Profit and Loss Account . . (3)	2,200
1937			1937		
Dec. 31	„ do. . . (7)	36	Dec. 31	„ do. . . (6)	2,200

Notes. (1) The provision for discount is made in proportion to the debentures outstanding.

(2) It may be preferred to write off the whole of the discount to Reserve in 1936.

(3) The transfers to Reserve follow general principles.

In order to ensure that the cash shall be available when required for the redemption of debentures, it is advisable to create a Sinking Fund. Such an equal annual amount is set aside and invested as will accumulate to the sum required by the due date. It is usual to credit the interest received on the investments to the Sinking Fund, and invest the interest with the next instalment of profits set aside, and the calculation of the annual sum therefore takes into account compound interest. If it were not for compound interest, the annual sum could be simply ascertained by

dividing the sum required to redeem the debentures by the number of years available for accumulation. Taking the interest into account, however, in practice involves recourse to compound interest tables, although it can be computed, at least for short periods, by ordinary arithmetical means. The next difficult point in practice is to determine the effective rate of interest to be taken into account, since it is necessary that the investments be reasonably secure, and the purchase price will vary from time to time. Moreover, income-tax rates vary, and only the *net* interest received can be invested.

For this reason, many companies prefer to take out a Sinking Fund policy with an insurance company, as this takes away all difficulties of computation, and (subject to the solvency of the insurance company) obviates any risk of the exact sum not being available when required.

Illustrations. (1) *To find the sum to be set aside and invested at 3 per cent (net) compound interest with yearly rests to produce £20,000 in five years.*

(*a*) *Arithmetically.*

	£
If there were invested at the end of the first year	100
Interest, end of the second year . .	3
Instalment, end of the second year . .	100
	203
Interest, end of the third year . . .	6·09
Instalment, end of the third year . .	100
	309·09
Interest, end of the fourth year . . .	9·2727
Instalment, end of the fourth year . .	100
	418·3627
Interest, end of the fifth year . . .	12·550881
Instalment, end of the fifth year . .	100
	£530·913581

If £530·913581 would be produced by £100 per annum, then £20,000 would be produced by

$$\frac{£100 \times 20{,}000}{530 \cdot 913581} = £3{,}766 \text{ 19s. 6d. per annum (approx.)}$$

(*b*) *Compound Interest Tables.* The sum to which an annuity of £1 per annum will amount in five years is found from the 3 per cent table to be £5·3091, hence to find the annual sum to invest to produce £20,000, divide £20,000 by 5·3091. It will be seen that this is the same as the above, subject to the number of decimal places.

(2) *To find the annual instalment to repay £20,000 at the end of ten years at 3 per cent compound interest.*

(*a*) *From Compound Interest Tables.*

$$\frac{£20{,}000}{11 \cdot 4639} = £1{,}744 \text{ 12s. 2d. per annum.}$$

(*b*) *Sinking Fund Assurance.* The annual premium on a 3 per cent basis would be £8 9s. 4d. per cent, i.e. £1,693 6s. 8d. payable at the *beginning* of the year.

If the annual instalment in (*a*) above were invested at the *beginning* of the year, the annual amount would be

$$\frac{£20{,}000}{11 \cdot 8078} = £1{,}693 \text{ approx.}$$

It would hardly be possible at the present time to obtain a 3 per cent return, however, in insurance.

Moreover, the interest is usually calculated ignoring the first instalment, and the annual cost of insurance would be greater than that of investing, though probably in the long run, taking possible loss on realization into account, it might be more economical.

The entries required to set up the fund are to debit Profit and Loss Account and credit Sinking Fund Account with the appropriation; credit Cash, debit Sinking Fund Investment Account with the sum invested. As interest is received, debit Cash, credit Sinking Fund Account, and invest with the next appropriation.

Illustration. *Taking the five year illustration previously computed, the accounts would appear as follows—*

SINKING FUND ACCOUNT

Year		£	s.	d.	Year		£	s.	d.
2	To Balance c/d .	7,646	19	2	1	By Profit and Loss Account .	3,766	19	6
					2	,, Cash—Interest	113	0	2
						,, Profit and Loss Account . . .	3,766	19	6
		£7,646	19	2			£7,646	19	2
3	To Balance c/d . .	11,643	6	10	3	By Balance b/d . .	7,646	19	2
						,, Cash—Interest .	229	8	2
						,, Profit and Loss Account . .	3,766	19	6
	£	11,643	6	10		£	11,643	6	10
4	To Balance c/d .	15,759	12	4	4	By Balance b/d . .	11,643	6	10
						,, Cash—Interest .	349	6	0
						,, Profit and Loss Account . . .	3,766	19	6
	£	15,759	12	4		£	15,759	12	4
5	To Balance c/d . .	20,000	0	0	5	By Balance b/d . .	15,759	12	4
						,, Cash—Interest, say	473	8	2
						,, Profit and Loss Account . . .	3,766	19	6
	£	20,000	0	0		£	20,000	0	0
	To Reserve Account[1] .	20,000	0	0		By Balance b/d . .	20,000	0	0

[1] On redemption of the debentures.

SINKING FUND INVESTMENT ACCOUNT

Year		£	s.	d.	Year		£	s.	d.
1	To Cash	3,766	19	6	5	By Cash—Sale of Investments . .	15,759	12	4
2	,, do.	3,879	19	8		(Assuming no loss or profit on sale.)			
3	,, do. . . .	3,996	7	8					
4	,, do.	4,116	5	6					
	£	15,759	12	4		£	15,759	12	4

Note. The last interest received and appropriation of profits would not be invested as the existing investments would be realized on the same day.

INSURANCE POLICY METHOD OF REDEMPTION

Where an insurance policy is taken out, the premiums paid will be debited to a Sinking Fund Insurance Policy Account. Particulars of the interest added will be obtained annually from the insurance company, and debited to the Policy Account and credited to Sinking Fund Account.

Any profit or loss on realization of investments, and any discount or premium on the debentures redeemed or purchased, must be transferred to the Sinking Fund. The transfer of the nominal value of the debentures redeemed from Sinking Fund to Reserve Account will close the Sinking Fund Account if all the debentures are redeemed.

Where only part of the debentures are redeemed, the operation of the Sinking Fund is upset, in that the balance remaining will not accumulate the amount required to redeem the remaining debentures. It is therefore necessary to compensate the Sinking Fund in some way. The best way is to recompute the annual instalments, but it is sometimes preferred to compute the shortage of interest each year and add that amount to the appropriation of profits, or to credit to the Sinking Fund each year the interest on the redeemed debentures, investing that amount with the instalment for the year. The last method is an expedient only, and rarely gives a reasonably exact result.

Where debentures are purchased between dividend dates, some authorities prefer to compute the accrued interest, and debit that portion of the purchase price to Debenture Interest Account. This adjustment is pedantically correct, but is little used in practice.

Illustration. *The Sinking Fund in respect of an issue of £40,000 5 per cent £100 Debentures, amounted to £24,000 on 1st January, represented by £25,000 3 per cent (net) Stock. The annual provision was £3,914. The interest on the stock was duly paid on 30th June and 31st December. The June amount was invested in the same stock at 93¾ (including expenses). On 31st December the directors decided to utilize the money available, together with the proceeds of sale of £10,000 Stock, in the purchase of debentures in the open market. The Stock realized 98, expenses £27, and the debentures cost 97½, expenses £45 10s. Write up the relevant accounts affected.*

5 PER CENT DEBENTURES ACCOUNT

19..		£	19..		£
Dec. 31	To Sundries, Redemption of Debentures— Cash (6) £13,988; Sinking Fund (7) 312	14,300	Jan. 1	By Balance b/f . .	40,000
	„ Balance c/d	25,700			
		£40,000			£40,000
			Jan. 1	By Balance b/d . .	25,700

SINKING FUND ACCOUNT

19..		£	19..		£
Dec. 31	To Reserve . . (10)	14,300	Jan. 1	By Balance b/f . .	24,000
	„ Balance c/d . .	14,858	June 30	„ Cash—Interest for half-year . (1)	375
			Dec. 31	„ do. . . . (3)	381
				„ Profit and Loss Account . . (4)	3,914
				„ Debentures Acct. (7)	312
				„ Sinking Fund Investment Acct. (9)	176
		£29,158			£29,158
			Jan. 1	By Balance b/d . .	14,858

3 PER CENT STOCK ON SINKING FUND INVESTMENT ACCOUNT

		Nominal				Nominal	
19 .		£	£	19 .		£	£
Jan. 1	To Balance b/f	25,000	24,000	Dec. 31	By Cash . (5)	10,000	9,773
June 30	" Cash . (2)	400	375		" Balance c/d(8)	15,400	14,778
Dec 31	" Sinking Fund Acct Profit (9)		176				
		£25,400	£24,551			£25,400	£24,551
Jan. 1	To Balance b/d (8)	15,400	14,778				
	" Cash-balance now invested (11)		80				

The cash available for investment is as follows—

	£	s.	d.
Interest received	381	0	0
Annual instalment	3,914	0	0
Proceeds of Sale of Investments .	9,773	0	0
Available	£14,068	0	0
Deduct Expenses	45	10	0
	£14,022	10	0

This would purchase $\frac{14022\frac{1}{2}}{97\frac{1}{2}}$ debentures

= 143 £100 debentures.

Notes. (1) The accounts should all be opened with the balances given in the question. Thereafter the entries should appear in the order shown by the figures in brackets.

(2) The Sinking Fund must be recomputed or compensated in some way in order that it may grow adequately to meet the balance of the debentures when due.

In some cases, the trustees for the debenture-holders are given the management of the Sinking Fund, the annual appropriation being invested in their names. Where this is so, the trustees may decide to utilize some or all of the money available in the purchase of the company's own debentures, rather than in the purchase of other investments. The debentures so purchased would

rarely be cancelled at once, and should be clearly distinguished from other investments. On the due date for repaying the debentures, the cancellation involves only a transfer in the books.

Illustration. *The Trust Deed of an issue of £40,000 4 per cent debentures provided that there be paid to the trustees annually a Sinking Fund instalment of £1,489. This was invested to produce 3 per cent. At 1st July, 1935, the Fund amounted to £25,612 represented by Stock of a nominal value of £26,000. On 31st December, 1935, the trustees invested in £1,000 of the company's debentures at 99½, the balance available being invested at par in 3 per cent Stock. On 30th June, 1936, the whole amount available was spent in buying £450 Debentures. Ignore expenses and write up the relevant accounts, to the nearest £, to 1st July, 1936, ignoring income-tax.*

SINKING FUND ACCOUNT

		£			£
1935 Dec. 31	To Balance c/d	27,491	1935 July 1	By Balance b/f	25,612
			Dec 31	„ Cash—Interest for half year	390
				„ Profit and Loss Account	1,489
		£27,491			£27,491
1936 June 30	To Balance c/d	27,914	1936 Jan. 1	By Balance b/d	27,491
			June 30	„ Cash—Interest for half-year	403
				„ Debenture Interest Account	20
		£27,914			£27,914

(*Continued on next page.*)

Illustration. *Assuming an issue of £40,000 4 per cent debentures, and that at the commencement of the last year the Sinking Fund stood at £37,450 (a sum slightly too high owing to debenture interest being higher than the investment rate assumed, and to the*

(*Continued on p.115*).

TRUSTEES FOR DEBENTURE HOLDERS: INVESTMENTS ON SINKING FUND ACCOUNT

		Debentures		Investments				Debentures		Investments	
		Nominal £	£	Nominal £	£			Nominal £	£	Nominal £	£
1935						1935					
July 1	To Balance b/f	—	—	26,000	25,612						
Dec. 31	,, Cash	1,000	995	884	884	Dec. 31	By Balance c/d	1,000	995	26,884	26,496
		£1,000	£995	£26,884	£26,496			£1,000	£995	£26,884	£26,496
1936						1936					
Jan. 1	To Balance b/d	1,000	995	26,884	26,496	June 30	By Balance c/f	1,450	1,418	26,884	26,496
June 30	,, Cash	450	423[1]								
		£1,450	£1,418	£26,884	£26,496			£1,450	£1,418	£26,884	£26,496

[1] It will be observed that the question says that the "amount available" was spent in acquiring "£450 Debentures," i.e. £450 debentures cost £423.

investments having been bought under par in some cases. The Sinking Fund was represented by £5,000 debentures purchased at an average price of 99 and £33,000 3 per cent Stock. Write up the accounts to the end of the last year, assuming that all interest was paid annually at the end of the year, ignoring income-tax, and that the debentures were then repaid at par. Work to the nearest £. The annual instalment was £1,489, and the investments realized 98.

4 PER CENT DEBENTURES

	£		£
To Sinking Fund Investment Account, Debentures Cancelled .	5,000	By Balance b/f	40,000
,, Cash . .	35,000		
	£40,000		£40,000

SINKING FUND ACCOUNT

	£		£
To Sinking Fund Investments Account .	160	By Balance b/f . .	37,450
,, Reserve .	40,000	,, Cash, Interest on 3% Stock . .	990
,, Profit and Loss Account[1] . . .	19	,, Debenture Interest Account . .	200
		,, Profit and Loss Account . . .	1,489
		,, Sinking Fund Investments Account	50
	£40,179		£40,179

SINKING FUND INVESTMENTS ACCOUNT

	Debentures		Stock			Debentures		Stock	
	Nominal £	£	Nominal £	£		Nominal £	£	Nominal £	£
To Balance b/f	5,000	4,950	33,000	32,500	By Cash .			33,000	32,340
,, Sinking Fund .		50			,, Debentures Account .	5,000	5,000		
					,, Sinking Fund .				160
	£5,000	£5,000	£33,000	£32,500		£5,000	£5,000	£33,000	£32,500

[1] This represents the excess cash available, and could be transferred to Reserve, but since it represents an over-provision, is preferably transferred back to Profit and Loss Account.

By Section 75 of the Act, where a company has redeemed any debentures previously issued, then—

(*a*) unless any provision to the contrary, whether express or implied, is contained in the Articles or in any contract entered into by the company; or

(*b*) unless the company has, by passing a resolution to that effect or by some other act, manifested its intention that the debentures shall be cancelled,

the company has power to reissue the debentures, either by reissuing the same debentures or by issuing other debentures in their place.

On reissue, the debentures rank as if they had never been redeemed (but must be stamped as if newly issued).

Particulars of redeemed debentures which are available for reissue must be included in every Balance Sheet.

Debentures deposited with a banker, etc., to secure advances from time to time on current account are not deemed to have been redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remain so deposited.

The best method of showing on the Balance Sheet debentures available for reissue is by a deduction, inset, from the total originally issued, extending the amount outstanding, e.g.

	£	£
4% Debentures	50,000	
Less Redeemed and available for reissue	10,000	
		40,000

MORTGAGES

Money raised on mortgage creates no difficulties in accounts. A Mortgage Account is credited with the amount raised, and the mortgage is normally shown as a liability on the Balance Sheet, not as a deduction from the asset.

When a mortgage is repaid out of profits, a reserve should be raised in the same way as on a redemption of debentures.

The following illustrations are representative examination questions—

Illustrations. (1) *A limited company made an issue of* £50,000 6 *per cent Debentures on* 31*st March,* 1926, *at* £95 *per cent redeemable in twenty years at par but with the right to redeem at any time, at a premium of* 5 *per cent, upon six months' notice being given. The company decided to exercise its option and on* 30*th September,* 1936, *notice of the intention to redeem was given accordingly.*

By 31*st March,* 1937, *one-half of the Sinking Fund relating to the issue had been raised. The Sinking Fund Investment was realized at a profit of* £600 *and the bank temporarily found the balance of the money required.*

You are required to show, by means of Ledger accounts, the entries relating to the redemption.

6 PER CENT DEBENTURE ACCOUNT

1937		£	1926		£
Mar. 31	To Sundry Debenture-holders . . .	50,000	Mar. 31	By Cash and Discount .	50,000

SUNDRY DEBENTURE-HOLDERS ACCOUNT

1937		£	1937		£
Mar. 31	To Cash . . .	52,500	Mar. 31	By Debenture Account.	50,000
				„ Premium on Redemption . .	2,500
		£52,500			£52,500

DEBENTURE DISCOUNT ACCOUNT

1926 Mar. 31	To Debenture Account .	£ 2,500	1937 Mar. 31	By General Reserve .	£ 2,500

PREMIUM ON REDEMPTION OF DEBENTURES ACCOUNT

1937 Mar. 31	To Sundry Debenture-holders . . .	£ 2,500	1937 Mar. 31	By Profit and Loss Account . . .	£ 2,500

DEBENTURE REDEMPTION FUND ACCOUNT

1937 Mar. 31	To General Reserve—Balance transferred	£ 25,600	1937 Mar. 31	By Balance b/d . .	£ 25,000
				„ Investments Account—Profit on Sale transferred . .	600

SINKING FUND INVESTMENTS ACCOUNT

1937 Mar. 31	To Balance b/d . .	£ 25,000	1937 Mar. 31	By Cash . . .	£ 25,600
	„ Redemption Fund Account—Profit transferred . . .	600			

BANK LOAN ACCOUNT

			1937 Mar. 31	By Cash . .	£ 26,900

GENERAL RESERVE ACCOUNT

1937 Mar. 31	To Debenture Discount Account . .	£ 2,500	1937 Mar. 31	By Debenture Redemption Fund . .	£ 25,600
	„ Balance c/d . .	23,100			
		£25,600			£25,600

Note. The profit realized on the sale of the investments could be utilized to reduce the charge to Profit and Loss Account in respect of the premium paid on redemption.

(2) *A company had in issue £100,000 in 7½ per cent Debentures and negotiated with the holders to*

convert into 4½ per cent Debentures. It proposed to issue £120 new stock for £100 old stock.

How do you consider that this conversion should be dealt with in the books of the company?

It is required that your answer take the form of three Balance Sheets, with explanatory notes—

No. 1 Balance Sheet showing the position immediately after conversion.

No. 2 Balance Sheet showing the position years later when—

(a) The assets originally acquired were due for replacement, a depreciation fund of an equivalent amount having been built up and invested outside the business.

(b) A debenture redemption fund equalling the amount of the debentures in issue had been built up and had been invested outside the business.

No. 3 Balance Sheet showing the position when the debentures had been redeemed and new assets, equalling in value the assets originally purchased, had been acquired.

It may be assumed that all investments were made at par but realized 5 per cent above par.

You are not required to incorporate in the Balance Sheets any items other than those necessary to illustrate your answer.

In consideration for the reduction of the Debenture Interest payable from £7,500 to £5,400 per annum, the principal of the debentures is increased from £100,000 to £120,000. It follows that the increase of £20,000 in the company's indebtedness on debentures should be debited to "Premium on Conversion of Debentures Account" and written off during the life of the 4½ per cent Debentures.

EXTRACT FROM NO. 1 BALANCE SHEET
showing the position immediately after conversion

Capital and Liabilities	£	*Assets*	£
£120,000 4½% Debentures	120,000	Sundry Assets, analysed under appropriate headings	100,000
		Premium on Conversion of Debentures	20,000

The Journal entry for the conversion is as follows—

		£	£
	Sundries . . . . . . *Dr.*		
	To 4½% Debentures		120,000
	7½% Debentures	100,000	
	Premium on Conversion of Debentures.	20,000	
	Being conversion of £100,000 7½% Debentures into £120,000 4½% Debentures.		

EXTRACT FROM NO 2 BALANCE SHEET
some years later

Capital and Liabilities	£	*Assets*	£
£120,000 4½% Debentures	120,000	Sundry Assets analysed under appropriate headings	100,000
Debenture Redemption Fund (*b*)	120,000	Investments of Debenture Redemption Fund (at cost) (*b*)	120,000
Depreciation Fund (*a*)	100,000	Investments of Depreciation Fund (at cost) (*a*)	100,000
		Premium on Conversion of Debentures	20,000

When the investments are realized, the profit will be credited to the appropriate Fund Account.

The assets which are replaced will be written off against the Depreciation Fund Account, which will then show a credit balance of £5,000, arising from the profit on sale of investments.

The proceeds of sale of the Debenture Redemption Fund Investments will be applied as to £120,000 in redeeming the debentures, the

balance of £6,000 being an addition to the company's bank balance.

The balances on the Fund Accounts represent undistributed profits which may be transferred to General Reserve Account and, in appropriate circumstances, may properly be applied in the issue of bonus shares, or, if the company's liquid resources are sufficient, in the distribution of dividends.

EXTRACT FROM NO. 3 BALANCE SHEET
after replacement of Assets and redemption of Debentures

Capital and Liabilities		£	*Assets*	£
General Reserve Account, being—			Sundry Assets analysed under appropriate headings (at cost) .	100,000
Amount transferred from Debenture Redemption Fund . . .	£126,000		Balance at Bank . .	11,000
Less Premium on Conversion of Debentures	20,000			
	106,000			
Amount transferred from Depreciation Fund	5,000			
		111,000		

Notes. (1) If the debentures were secured on any assets of the company a statement to that effect must be included in Balance Sheets Nos. 1 and 2 (Section 124 (3), Companies Act, 1929).

(2) It is assumed that the assets replaced were (*a*) fixed, and (*b*) had no scrap value.

(3) The premium on conversion of debentures is debited to the Debenture Redemption Fund, which arises from accumulated profits set aside in order to provide sufficient funds to repay the debentures. By means of this transfer, the premium is written off against profits during the life of the 4½ per cent debentures.

(4) Balance at Bank in No. 3 Balance Sheet arises from the profits on sale of investments of—

	£
Debenture Redemption Fund . .	6,000
Depreciation Fund	5,000
	£11,000

(3) *The Balance Sheet of B & Co. Ltd., at 31st July, was—*

	£
Authorized Capital—	
100,000 *Ordinary Shares of £1 each*	100,000
100,000 $5\frac{1}{2}$% *Cumulative Preference Shares of £1 each*	100,000
	£200,000

	£
Issued Capital—	
75,000 *Ordinary Shares*	75,000
75,000 *Preference Shares*	75,000
7% *Mortgage Debentures (redeemable at par in* 1940)	35,000
Creditors	54,632
Profit and Loss Account	15,484
	£255,116

	£
Freehold Properties	47,320
Plant, Machinery, and Motor Vehicles	32,765
Stock	83,472
Book Debts	72,943
Bank Balance	18,616
	£255,116

The Debenture Trust Deed provides that the company may redeem the debentures at a premium of 5 *per cent at any time before the due date, and to enable this option to be exercised the necessary resolutions are passed for the issue of* 25,000 $5\frac{1}{2}$ *per cent cumulative preference shares at par and* 25,000 *ordinary shares at a premium of* 2*s.* 6*d. per share. In both cases* 5*s. per share is payable on application and the balance on allotment, and the shares are all taken up and the debentures are duly redeemed.*

Show the Cash Book and Ledger Accounts recording these transactions, and prepare a Balance Sheet on completion, assuming that items not affected have remained the same.

CASH BOOK

	£		£
To Balance b/f	18,616	By Sundry Debenture-holders	36,750
,, Application and Allotment Account—		,, Balance c/d	34,991
5s. per share on.			
25,000 Pref. Shares	6,250		
25,000 Ord Shares	6,250		
,, Application and Allotment Account—			
Balances on Allotment:			
25,000 Pref Shares	18,750		
25,000 Ord. Shares	21,875		
	£71,741		£71,741
To Balance b/d	34,991		

5½ PER CENT CUMULATIVE PREFERENCE SHARES ACCOUNT

	£		£
To Balance c/d	100,000	By Balance b/f	75,000
		,, Application and Allotment Account	25,000
£	100,000	£	100,000
		By Balance b/d.	100,000

ORDINARY SHARES ACCOUNT

	£		£
To Balance c/d	100,000	By Balance b/f	75,000
		,, Application and Allotment Account	25,000
£	100,000	£	100,000
		By Balance b/d	100,000

PREMIUM ON SHARES ACCOUNT

			£
		By Application and Allotment Account	3,125

APPLICATION AND ALLOTMENT ACCOUNT

	Pref. Shares £	Ord. Shares £		Pref. Shares £	Ord. Shares £
To Share Capital Accounts	25,000	25,000	By Cash, 5s. per share on application	6,250	6,250
,, Premium on Shares Account		3,125	,, Cash, Balance on allotment	18,750	21,875
	£25,000	£28,125		£25,000	£28,125

7 PER CENT MORTGAGE DEBENTURES ACCOUNT

	£		£
To Sundry Debenture-holders .	35,000	By Balance b/f . . .	35,000

SUNDRY DEBENTURE HOLDERS

	£		£
To Cash	36,750	By Mortgage Debentures Account	35,000
		„ Profit and Loss Account—Premium on Redemption .	1,750
	£36,750		£36,750

PROFIT AND LOSS ACCOUNT

	£		£
To Sundry Debenture-holders Account—Premium on Redemption	1,750	By Balance b/f . . .	15,484
„ Balance c/d . . .	13,734		
	£15,484		£15,484
		By Balance b/d .	13,734

BALANCE SHEET (after completion)

		£		£
Capital, Authorized, issued and fully paid—			Freehold Properties . .	47,320
100,000 Ord. Shares of £1 each . .	£100,000		Plant, Machinery and Motor Vehicles . . .	32,765
100,000 5½% Cum. Pref. Shares of £1 ea.	100,000		Stock . . .	83,472
		200,000	Book Debts . . .	72,943
Premium on Shares .		3,125	Bank Balance .	34,991
Creditors		54,632		
Profit and Loss Account .		13,734		
	£	271,491	£	271,491

Notes. (1) Since the money required for redeeming the debentures has been provided by the issue of shares, there is no need to make a transfer to reserve.

(2) If preferred, the premium on the repayment of debentures can be charged to Premium on Shares Account.

(3) The basis of valuation of the fixed assets is not given.

(4) *A limited company has raised additional working capital by means of Mortgage Debentures repayable at the end of ten years by the creation of a Sinking Fund for that purpose. The company's assets include Plant and Machinery costing £10,000*

and having a life of ten years. Provision has to be made by means of a sinking fund for the renewal of the asset at the end of that period. Assuming the Balance Sheet at the commencement of the period to be as under, and that proper provision has been made annually in the accounts for the purposes of redeeming the debentures and renewing the asset, you are required to show the position immediately before and after the redemption of the debentures and renewal of the asset.

BALANCE SHEET

Liabilities	£	Assets	£
Issued Share Capital .	100,000	*Plant and Machinery— at Cost* . . .	10,000
Mortgage Debentures .	20,000	*Other Assets* . . .	125,000
Profit and Loss Account	15,000		
	£135,000		£135,000

BALANCE SHEET (before Redemption)

	£		£
Issued Share Capital .	100,000	Plant and Machinery at Cost .	10,000
Mortgage Debentures .	20,000	Other Assets	125,000
Debentures Redemption Sinking Fund	20,000	Debenture Redemption Sinking Fund Investments . .	20,000
Depreciation Fund . .	10,000	Depreciation Fund Investments .	10,000
Profit and Loss Account .	15,000		
£	165,000	£	165,000

BALANCE SHEET (after Redemption)

	£		£
Issued Share Capital	100,000	Plant and Machinery at cost .	10,000
General Reserve	20,000	Other Assets	125,000
Profit and Loss Account .	15,000		
£	135,000	£	135,000

Notes. (1) It has been assumed that both sinking funds are invested outside the business and realized without profit or loss.

(2) It has been assumed that no change has taken place in the book value of "other assets," or in the balance of Profit and Loss Account.

(5) *A company issued £2,000 5 per cent Debenture Stock at par on 1st January, 1936. The stock was to be redeemed at the end of ten years. To provide for redemption a ten years' endowment policy was taken out, also on 1st January, 1936. Assume the annual premium to be £180, and reckon the surrender value at the amount of premiums paid, plus 2 per cent compound interest. Write up the necessary accounts in the books of the company for the years 1936, 1937, and 1938, and state what entries should be made at the end of the tenth year if the amount realized on the policy were more or less than the surrender value appearing in the company's books.*

5 PER CENT DEBENTURE STOCK ACCOUNT

		£	s.	d.			£	s.	d.
					1936 Jan. 1	By Cash . . .	2,000	0	0

SINKING FUND ACCOUNT

		£	s.	d.			£	s.	d.
1936 Dec. 31	To Balance c/d . .	183	12	0	1936 Jan. 1	By Profit and Loss Account . .	180	0	0
					Dec. 31	„ Policy Account .	3	12	0
		£183	12	0			£183	12	0
1937 Dec. 31	To Balance c/d . .	370	17	5	1937 Jan. 1	By Balance b/d . .	183	12	0
					„ 1	„ Profit and Loss Account .	180	0	0
					Dec. 31	„ Policy Account	7	5	5
		£370	17	5			£370	17	5
1938 Dec. 31	To Balance c/d . .	561	17	9	1938 Jan. 1	By Balance b/d . .	370	17	5
					„ 1	„ Profit and Loss Account . .	180	0	0
					Dec. 31	„ Policy Account	11	0	4
		£561	17	9			£561	17	9
					1939 Jan. 1	By Balance b/d . .	561	17	9

SINKING FUND ENDOWMENT POLICY ACCOUNT

		£	s.	d.			£	s.	d.
1936					1936				
Jan. 1	To Cash . . .	180	0	0	Dec. 31	By Balance c/d . .	183	12	0
Dec. 31	„ Sinking Fund Account—Interest .	3	12	0					
		£183	12	0			£183	12	0
1937									
Jan. 1	To Balance b/d . .	183	12	0	1937				
	„ Cash . . .	180	0	0	Dec. 31	By Balance c/d .	370	17	5
Dec. 31	„ Sinking Fund Account—Interest	7	5	5					
		£370	17	5			£370	17	5
1938					1938				
Jan. 1	To Balance b/d . .	370	17	5	Dec 31	By Balance c/d .	561	17	9
	„ Cash . . .	180	0	0					
Dec. 31	„ Sinking Fund Account—Interest .	11	0	4					
		£561	17	9			£561	17	9
1939									
Jan. 1	To Balance b/d . .	561	17	9					

At the end of the tenth year, any difference arising on the policy account owing to the amount realized by the policy being more or less than the surrender value appearing in the books would be transferred to the Sinking Fund Account. From the latter account, £2,000 should be transferred to reserve and the balance to Profit and Loss Account.

(6) *In* 1934 *a company made an issue of* 1,000 5 *per cent Debentures of* £100 *each at* 96. *The terms of issue provided for the redemption of* £2,000 *annually, commencing in* 1937, *either by purchase in the market or by drawings at par at the company's option. The expenses of the issue were written off in* 1934 *and* £1,000 *was written off the Debenture Discount Account in each of the years* 1934, 1935, *and* 1936.

In December, 1937, *the company purchased for cancellation* £700 *of its Debentures at* 94, £1,200 *at* 94½ *and* £100 *at* 95, *the expenses amounting to* £5 5*s*.

Give the entries to be made in the company's books in connexion with the above transactions, dealing

with the profit on redemption in the way you consider fit, and show also the entries which would appear in consequence in the company's published accounts as on 31st December, 1937. Ignore interest.

5 PER CENT DEBENTURES ACCOUNT

		£			£
1937 Dec.	To Debenture Redemption Account . .	2,000	1934 ?	By Sundries . .	100,000
" 31	" Balance c/f . .	98,000			

DEBENTURE DISCOUNT ACCOUNT

		£	s.	d.			£	s.	d.
1934 ?	To Debentures Account	4,000	0	0	1934 Dec. 31	By Profit and Loss Account . .	1,000	0	0
					1935 Dec. 31	" do. . .	1,000	0	0
					1936 Dec. 31	" do. . .	1,000	0	0
					1937 Dec. 31	" Balance c/f . .	1,000	0	0

DEBENTURE REDEMPTION ACCOUNT

		£	s.	d			£	s	d.
1937 Dec.	To Cash £700 Debentures @ 94	658	0	0	1937 Dec.	By Debentures Account	2,000	0	0
	" Cash £1,200 Debentures at 94½ .	1,134	0	0					
	" Cash £100 Debentures @ 95 . .	95	0	0					
	" Cash Expenses .	5	5	0					
" 31	" Reserve Account, Profit on Redemption . .	107	15	0					

RESERVE ACCOUNT

		£	s.	d.			£	s.	d.
1937 Dec. 31	To Balance c/f . .	2,000	0	0	1937 Dec. 31	Debenture Redemption Account . .	107	15	0
						Profit and Loss Account	1,892	5	0

BALANCE SHEET AS AT 31ST DECEMBER, 1937

	£	s.	d.		£	s.	d.
5% Debentures	98,000	0	0	Discount on Debentures—*less* amounts written off . .	1,000	0	0
Reserve	2,000	0	0				

Notes. (1) It may be considered desirable to write off further discount, but this item has been written off liberally already, and so long as it is gradually extinguished in proportion to the benefit received from the debentures in each year, drastic writing off is unnecessary.

(2) It is assumed that no Sinking Fund exists nor is one to be provided.

(7) *On 1st January, 1936, Mosaics Ltd. issued £20,000 of debentures at a discount of 6 per cent repayable out of profits by annual drawings of £4,000.*

The drawings were duly made on 31st December in each year and repayment made on the following day. The directors decided to write off the discount on issue over the period of the debentures in such a way as to charge each year with an amount proportionate to the debentures outstanding in that year.

Calculate the amount of discount to be written off each year and show the Journal entries required to record the transactions taking place on 31st December, 1938.

Year	*Debentures Outstanding*	*Ratio*	*Proportion to be written off*	*Amount to be written off*
	£			£
1936	20,000	5	5/15ths	400
1937	16,000	4	4/15ths	320
1938	12,000	3	3/15ths	240
1939	8,000	2	2/15ths	160
1940	4,000	1	1/15th	80
		15		£1,200

JOURNAL

		£	£
1938 Dec. 31	Debentures Account . . . . *Dr.* To Cash . . . . . . Repayment of Debentures by drawings.	4,000	4,000
	Profit and Loss Account . . *Dr.* To Debenture Discount Account . Discount written off.	240	240
	Profit and Loss Account . . *Dr.* To Reserve Account . . . Transfer of amount of profits applied in redeeming debentures.	4,000	4,000

Note. In most cases, it would be considered sufficiently prudent to charge the discount against Reserve.

(8) *On 30th June the following balances stood in the books of a company*—

	£
4% *First Mortgage Debenture Stock*	100,000
Debenture Redemption Fund.	106,540
Debenture Redemption Fund Investments—	
£40,000 3½% *War Stock*	38,630
£40,000 3½% *Conversion Stock* . . .	39,034
£20,000 5% *Conversion Stock* . . .	22,855
£6,000 4% *Funding Loan*	6,021

On the same day the investments were sold; War Stock at 106, *the* 3½ *per cent Conversion Stock at* 108, *the* 5 *per cent Conversion at* 120, *and the Funding Loan at* 118. *On* 1st *July the Debentures were redeemed at a premium of* 5 *per cent.*

Write up the accounts concerned (other than Cash Account), bringing down the balances, if any, after the above transactions have been completed and stating how such balances should be dealt with in the next Balance Sheet of the company.

(*No Journal entries are required and Brokers' charges may be ignored.*)

4 PER CENT DEBENTURE STOCK ACCOUNT

		£			£
June 30	To Sundry Debenture-holders on Redemption . . .	100,000	June 30	By Balance b/f . .	100,000

DEBENTURE REDEMPTION FUND INVESTMENTS ACCOUNT

		£	£			£	£
June 30	To Balance b/f—			June 30	By Cash—		
	£40,000 3½% War Stock .	38,630			3½% War Stock @ 106 . .	42,400	
	£40,000 3½% Conversion Stock . .	39,034			3½% Conversion Stock @ 108	43,200	
	£20,000 5% do.	22,855			5% do. @ 120	24,000	
	£6,000 4% Funding Loan	6,021			4% Funding Loan @ 118	7,080	
			106,540				116,680
	" Redemption Fund—Profit on Realization		10,140				
		£	116,680			£	116,680

DEBENTURE REDEMPTION FUND ACCOUNT

		£			£
June 30	To Sundry Debenture-holders, premium of 5% on Redemption of £100,000 Debentures . .	5,000	June 30	By Balance b/f . .	106,540
	" Reserve—amount equal to nominal value of debentures redeemed . .	100,000		" Investments Account—profit on realization . .	10,140
	" Profit and Loss Account . . .	11,680			
	£	116,680		£	116,680

SUNDRY DEBENTURE-HOLDERS ACCOUNT

		£			£
June 30	To Cash . . .	105,000	June 30	By Debenture Stock Account .	100,000
				" Redemption Fund—premium . .	5,000
	£	105,000		£	105,000

RESERVE ACCOUNT

					£
			June 30	By Debenture Redemption Fund .	100,000

PROFIT AND LOSS ACCOUNT

					£
			June 30	By Debenture Redemption Fund . .	11,680

The credit balance remaining on the Redemption Fund, £11,680, represents an over-provision, i.e. over-appropriation of profits, for the redemption, and can be taken back to the credit of Profit and Loss Account. If preferred, of course, it can be taken to Reserve or otherwise dealt with; the profits are actually available in cash.

In the next Balance Sheet, unless the debentures have been cancelled, a note should appear that they are available for reissue. The Reserve will appear in the Balance Sheet without any

qualification. The amount of £11,680 credited to Profit and Loss Account should preferably be shown "inset" as an addition distinct from the profits for the year, in arriving at the total of the balance in that account.

(9) *The Balance Sheet of a firm was as follows—*

	£		£
Creditors	60,538	*Freehold Property*	108,000
Capital	362,736	*Plant and Machinery*	56,052
		Stock and Work-in-Progress	132,664
		Patents, etc	10,000
		Book Debts	67,822
		Cash	8,736
		Goodwill	40,000
	£423,274		£423,274

A company was formed with an authorized capital of £300,000, divided equally into Preference and Ordinary Shares of £1 each, to take over the assets and liabilities of the firm, with the exception of the cash. The purchase consideration was £350,000, payable in Debenture Stock at par, to the extent of £50,000, in 100,000 each of fully-paid Preference and Ordinary Shares at par, and the balance in cash.

The company created £100,000 Debenture Stock, secured by a charge on the freehold property, and issued a prospectus in which the balances of the Debenture Stock and Shares were offered to the public, payable as follows—

	Per Share s. d.	Per £100 Stock £
On Application	2 6	20
„ Allotment	7 6	80
„ First Call	5 0	—
„ Second Call	5 0	—

All the shares and stock were applied for, allotted and paid for when due, except the Second Call on 400 *Ordinary Shares, which is still unpaid.*

Enter the above transactions in the appropriate accounts in the company's books and draw up a Balance Sheet to show the position on completion of the entries.

(No Journal entries are required.)

VENDORS ACCOUNT

	£		£
To Creditors	60,538	By Freehold Property	108,000
,, Debenture Stock Account	50,000	,, Plant and Machinery	56,052
,, Preference Share Capital Account	100,000	,, Stock and Work-in-progress	132,664
,, Ordinary Share Capital Account	100,000	,, Patents, etc.	10,000
,, Cash	100,000	,, Book Debts	67,822
		,, Goodwill	36,000
£	410,538	£	410,538

PREFERENCE SHARE CAPITAL ACCOUNT

			£
		By Vendor	100,000
		,, Application and Allotment Account	25,000
		,, First Call Account	12,500
		,, Second Call Account	12,500
		£	150,000

ORDINARY SHARE CAPITAL ACCOUNT

			£
		By Vendor	100,000
		,, Application and Allotment Account	25,000
		,, First Call Account	12,500
		,, Second Call Account	12,500
		£	150,000

DEBENTURE STOCK ACCOUNT

			£
		By Vendor	50,000
		,, Application and Allotment Account	50,000
		£	100,000

SHARES APPLICATION AND ALLOTMENT ACCOUNTS

	Pref. Shares £	Ord. Shares £		Pref. Shares £	Ord. Shares £
To Share Capital Accounts	25,000	25,000	By Cash—		
			Application Money	6,250	6,250
			Allotment Money	18,750	18,750

DEBENTURE STOCK APPLICATION AND ALLOTMENT ACCOUNT

	£		£
To Debenture Stock Account .	50,000	By Cash—Application Money .	10,000
		„ „ Allotment Money .	40,000

FIRST CALL ACCOUNT

	Pref. Shares £	Ord Shares £		Pref. Shares £	Ord. Shares £
To Share Capital Accounts . . .	12,500	12,500	By Cash . .	12,500	12,500

SECOND CALL ACCOUNT

	Pref. Shares £	Ord. Shares £		Pref Shares £	Ord. Shares £
To Share Capital Accounts . .	12,500	12,500	By Cash . . .	12,500	12,400
			„ Balance c/d . .		100
To Balance b/d . .		100			

CASH BOOK

	£		£
To Application and Allotment Accounts—		By Vendor—Balance of Purchase Consideration . .	100,000
Amounts received on Application:		„ Balance c/d . . .	49,900
Pref. Shares . . .	6,250		
Ord. Shares . .	6,250		
2s. 6d. per share on 50,000 Shares of each Class.			
Debenture Stock—£20% on £50,000 Stock	10,000		
„ Application and Allotment Accounts—			
Amounts received on Allotment:			
Pref. Shares . . .	18,750		
Ord. Shares . .	18,750		
7s. 6d. per share on 50,000 Shares of each class.			
Debenture Stock—£80% on £50,000 Stock .	40,000		
„ First Call Accounts—			
Pref. Shares .	12,500		
Ord. Shares .	12,500		
5s. per share on 50,000 shares of each class.			
„ Second Call Accounts—			
Pref. Shares . . .	12,500		
Ord. Shares . . .	12,400		
5s. per Share on 50,000 Pref. and 5s. per Share on 49,600 Ord. Shares.			
£	149,900	£	149,900
To Balance b/d	49,900		

BALANCE SHEET

Capital and Liabilities	£	£	*Assets*	£
Capital—			Goodwill at Cost	36,000
Authorized:			Freehold Property, at Cost	108,000
150,000 Pref. Shares of £1 each	150,000		Plant and Machinery, at Cost	56,052
150,000 Ord. Shares of £1 each	150,000		Patents, etc., at Cost	10,000
	£300,000		Stock and Work-in-Progress	132,664
Issued:			Book Debts	67,822
150,000 Pref. Shares of £1 each, fully paid	150,000		Cash	49,900
150,000 Ord Shares of £1 each fully called £150,000 *Less* Calls in arrear 100	149,900			
		299,900		
Mortgage Debenture Stock		100,000		
Creditors		60,538		
	£	460,438	£	460,438

Note. It has not been thought necessary to show the individual asset accounts.

CHAPTER VI

ALTERATIONS OF SHARE CAPITAL

INCREASE — Conversion— Consolidation — Subdivision — Reduction of Capital

PROVIDED the company is empowered by its Articles (which can be altered to give such power) it can alter its share capital in the following ways—

(1) Increase the nominal capital.

(2) Convert fully-paid shares into stock.

(3) Reconvert stock into shares of any amount.

(4) Consolidate its shares into shares of larger amount.

(5) Subdivide its shares into shares of a smaller amount.

(6) Cancel unissued capital.

The method of making any of the above alterations is for the company in general meeting to pass a resolution, either ordinary, extraordinary, or special, as specified in the Articles, and for the company then to give notice to the Registrar of Companies. In the case of an increase, the additional stamp duties must be paid.

(7) Reduce its capital. This requires a special resolution, and must be confirmed by the Court on petition. Before giving its sanction, the Court has to be satisfied as to the position of creditors. The scheme does not take effect until there has been filed with the Registrar of Companies an office copy of the order of the Court and a minute of the reduction approved by the Court.

The actual book-keeping involved in the alterations is as follows.

Increase of Capital. Until the new shares are issued, no entry is required. On issue of the shares, the entries are those already dealt with in Chapter III.

Conversion into Stock. Stock has been defined as "a bundle of shares." Shares cannot be converted into stock until fully paid. Stock has the advantages that it requires no distinctive numbers, and can be transferred in any fraction permitted by the Articles. In practice, the conversion may be recorded by changing the heading of the Share Capital Account to Capital Stock Account, but it is better to close the Share Capital Account and open the Capital Stock Account by a transfer through the Journal.

Reconversion into Shares. This is simply the reverse of the above.

Consolidation. Since this involves only a change in the nominal value and number of the shares, but not the total amount of capital (e.g. 400,000 shares of 2s. each consolidated into 40,000 shares of £1 each), a note of the new values at the head of the account will suffice, or it may be preferred to make a Journal entry, e.g.

		£	£
2s. Share Capital Account . . .	*Dr.*	40,000	
To £1 Share Capital Account . .			40,000
Consolidation of 400,000 2s. shares into 40,000 £1 shares.			

Subdivision. This is the reverse process to consolidation, and may be recorded by note or Journal entry in the same way. Care must be taken that where partly-paid shares are concerned, the proportion credited as paid must not be varied, e.g. if 40,000 shares of £5 each, £3 paid, are subdivided into 200,000 £1 shares, these must be 12s.

paid, although it would be permissible to divide into 100,000 £1 shares fully paid, and 100,000 £1 shares, 4s. paid, or any other division which preserved the *totals* of issued, paid-up, and uncalled capital.

Cancellation involves no book-keeping. Only unissued capital is concerned.

Reduction may take many forms, e.g. a return of surplus moneys to the members in reduction of their shares, or the writing down of capital in order to write off losses and write down assets which have been lost or heavily depreciated. In the case of a return to the members, the entries are Dr. Share Capital Account, Cr. Cash, but in the other case mentioned, they are more complicated; a Capital Reduction Account must be opened, to which is credited the amounts written off the capital. The balance of this account is then available for writing down assets and writing off losses, in accordance with the scheme.

Illustration. *The following is the Balance Sheet of X Ltd.—*

	£		£
Share Capital, 48,000 £1 *shares*, 16*s*. 8*d*. *paid*	40,000	*Goodwill*	18,000
Creditors	15,000	*Plant*	19,000
Bank Overdraft	4,000	*Furniture, etc*	1,500
		Stock	8,000
		Debtors	3,000
		Profit and Loss Account	8,500
		Preliminary Expenses	1,000
	£59,000		£59,000

The following Capital Reduction Scheme is duly sanctioned by the Court—

The Share Capital to be reduced to 48,000 *shares of* 6*s*. 8*d*. *each*, 3*s*. 4*d*. *paid, and the amount so*

provided to be utilized to write off the Profit and Loss Account debit balance, the preliminary expenses and goodwill, and to reduce the following assets by the amounts stated, viz. Plant by £2,500, Furniture by £1,200, and Stock by £500, the balance being utilized to provide a 10 per cent reserve for doubtful debts.

JOURNAL

		£	£
	Share Capital Account . . . *Dr.*	32,000	
	To Capital Reduction Account .		32,000
	Reduction of share capital to 48,000 shares of 6s. 8d. each, 3s. 4d. paid, per scheme authorized by the Court this day.		
	Capital Reduction Account . *Dr*	32,000	
	To Profit and Loss Account . .		8,500
	Preliminary Expenses . .		1,000
	Goodwill		18,000
	Plant		2,500
	Furniture		1,200
	Stock		500
	Reserve for Doubtful Debts .		300
	Amounts written off per scheme		

The words "and reduced" may be ordered by the Court to be added to the name of the company after the word "limited" for such period as the Court directs. This order is rarely made, as the use of the words may give rise to misunderstandings, particularly where the company carries on business abroad.

The following illustrations are from representative examination questions—

Illustrations. (1) *The issued capital of Blank Ltd. was £1,500,000, consisting of 1,000,000 8 per cent Participating Preference Shares of £1 each and 2,000,000 Ordinary Shares of 5s. each, all fully paid. On 14th May, 1936, resolutions were duly passed by the members reducing the paid-up capital to £800,000*

consisting of 1,600,000 *new Ordinary Shares of* 10s. *each fully paid.*

Fixed assets which stood in the Balance Sheet as on 30*th June,* 1935, *at* £1,400,000 *were valued for the capital reduction scheme at* £850,000, *and the amount by which the capital was to be reduced was to be applied in writing off this difference in value and in extinguishing the debit balance on Profit and Loss Account, as on* 30*th June,* 1935, *of* £150,000.

The scheme was confirmed by Order of Court, dated 25*th June,* 1936, *which did not become effective until registered on* 10*th July,* 1936.

Set out the items concerned in the company's Balance Sheet as on 30*th June,* 1936, *in the manner you consider most appropriate.*

BLANK, LTD.

BALANCE SHEET AS AT 30TH JUNE, 1936

Capital and Liabilities	£	*Assets*	£	£
Share Capital— Authorized: Issued: 1,600,000 Ord. Shares of £1 each, fully paid (Reduced by Order of Court dated 25th June, 1936, from 1,000,000 8% Participating Pref. Shares of £1 each and 2,000,000 Ord. Shares of 5s. each, fully paid (see note)).	800,000	Fixed Assets (detailed), at Cost, *less* Depreciation written off to 30th June, 1935	1,400,000	
		Less Amount written off on capital reduction sanctioned by Order of Court dated 25th June, 1936 (see note)	550,000	850,000
		Profit and Loss Account as at 30th June, 1935	150,000	
		Less Amount written off on capital reduction scheme (see note)	150,000	—

Note. The capital reduction scheme is not legally effective until registered with the Registrar of Companies. Registration was effected on 10th July, 1936.

Alternatively, as shown in the next example, the actual amounts written off need not be shown in the Balance Sheet, but the basis of valuation of the

fixed assets must be shown in every Balance Sheet laid before a General Meeting of the Company.

(2) *The Balance Sheet of Depressions Ltd. on 30th September was as follows—*

Capital and Liabilities	£	£	*Assets*	£
Authorized Capital—			*Land and Buildings, at cost* . .	6,000
50,000 6% *Cum. Pref. Shares of £1 each* .	50,000		*Plant and Machinery, at cost* less *Depreciation*	23,500
100,000 *Ord. Shares of* 10s. *each* . . .	50,000		*Goodwill, at cost*	2,500
	£100,000		*Stock-in-Trade*	16,500
Issued Capital—			*Sundry Debtors*	23,000
50,000 6% *Cum. Pref. Shares of £1 each* .	50,000		*Balance at Bank and Cash in hand*.	3,000
80,000 *Ord. Shares of* 10s. *each,* 7s. 6d. *paid up* . . .	30,000		*Profit and Loss Account, amount at debit*	20,500
		80,000		
Sundry Creditors . . .		15,000		
(Note. *The Preference dividend is in arrear for* 2 *years.*)				
		£95,000		£95,000

Application was made to the Court on 21st October, and sanction (operative as from 30th September) was obtained—

(1) *To reduce the Preference shares to shares of* 16s. *each, fully paid, and to cancel the arrears of dividend.*

(2) *To reduce the Ordinary shares to shares of* 5s. *each,* 2s. 6d. *paid up, and to increase the authorized Ordinary share capital to* 120,000 *shares of* 5s. *each.*

(3) *To write off the Goodwill and to reduce the value of the Plant and Machinery by* £3,500, *and to write off Book debts to the value of* £2,500, *which were regarded as bad.*

(4) *To cancel the adverse balance on Profit and Loss Account.*

Show the Journal entries required to record the effect of the Order of the Court, with sufficient narrative to explain their purpose, and draw up an amended Balance Sheet, applying any available balance in such manner as you think fit.

JOURNAL

		£	£
Sept. 30	Preference Share Capital Account *Dr.*	10,000	
	To Capital Reduction Account .		10,000
	Reduction to Shares of 16s. each, fully paid, of 50,000 Preference Shares of £1 each, as sanctioned by order of the Court dated 21st October (arrears of dividend being cancelled)		
	Ordinary Share Capital Account . *Dr.*	20,000	
	To Capital Reduction Account .		20,000
	Reduction to shares of 5s. each, 2s. 6d. paid, of 80,000 Ordinary Shares of 10s. each, 7s. 6d. paid, as sanctioned by order of the Court, dated 21st October (Authorized Ordinary Capital increased to 120,000 shares of 5s. each.)		
	Capital Reduction Account . *Dr.*	30,000	
	To Goodwill Account . . .		2,500
	,, Plant and Machinery Account .		3,500
	,, Sundry Debtors . . .		2,500
	,, Profit and Loss Account . .		20,500
	,, Reserve for Doubtful Debts .		1,000
	Amounts written off Assets and provision as per scheme of reduction sanctioned by the Court on 21st October.		

DEPRESSIONS LIMITED

Amended Balance Sheet as at 30th September, 19..

Capital and Liabilities	£	£	*Assets*	£	£
Authorized Capital, after reduction sanctioned by the Court—			Land and Buildings at cost . .		6,000
50,000 6% Cum. Pref. Shares of 16s. each .	40,000		Plant and Machinery at cost, less depreciation and amount written off on reduction of Capital .		20,000
120,000 Ord. Shares of 5s. each . . .	30,000		Goodwill at cost, less amount written off on reduction of Capital .		—
	£70,000		Stock-in-Trade .		16,500
Issued Capital, after reduction sanctioned by the Court—			Sundry Debtors .	20,500	
50,000 6% Cum. Pref. Shares of 16s. each, fully paid . .	40,000		*Less* Reserve for Doubtful Debts . . .	1,000	
80,000 Ord. Shares of 5s. each, 2s. 6d. paid .	10,000				19,500
		50,000	Balance at Bank and Cash in hand		3,000
Sundry Creditors . . .		15,000			
		£65,000			£65,000

Note. If preferred, as shown in the previous example, details of the reduction can be shown in the Balance Sheet.

(3) *With the approval of the Court and the sanction of the Debenture-holders, the Merlewood Manufacturing Company Ltd. has decided upon a scheme of capital reduction and reorganization as at 31st March.*

The Balance Sheet of the company at that date, in summarized form, is as under—

MERLEWOOD MANUFACTURING COMPANY, LIMITED

SUMMARIZED BALANCE SHEET, 31ST MARCH

	£	£		£
6% Preference Shares £1 each fully paid		421,840	*Land, Buildings, Plant and Machinery*	943,200
Ordinary Shares £1 each fully paid		819,330	*Stock and Work-in-Progress*	318,724
5½% Sinking Fund 1st Mortgage Debentures	315,000		*Debtors*	180,391
Interest accrued thereon less tax	5,969		*Investments*	398,390
		320,969	*Goodwill*	379,468
6% Convertible Debentures	636,700		*Discount and Expenses on issue of Debentures*	31,735
Interest accrued thereon less tax	15,136		*Profit and Loss Account*	230,044
		651,836		
Loan from Bankers, secured		100,000		
Reserves		68,600		
Creditors		99,377		
		£2,481,952		£2,481,952

The material points in the scheme are—

(i) *Each £100 of Convertible 6 per cent Debentures is to be exchanged for £35 of Non-convertible 6 per cent Debentures, £50 of 6½ per cent Preference Shares, and £15 of Ordinary Shares.*

(ii) *Each existing 6 per cent Preference Share is to be written down from 20s. to 12s. 6d., of which 10s. will be represented by 6½ per cent Preference Shares and 2s. 6d. by Ordinary Shares.*

(iii) *Each existing Ordinary Share will be written down from 20s. to 3s. 4d.*

(iv) *Both classes of shares will then be consolidated into shares of £1.*

(v) *The Argentum Trust Limited will apply for* £375,000 *Ordinary Shares paying cash in full on application.*

(vi) *The rate of dividend on the Preference Shares is raised to* 6½ *per cent.*

(vii) *The Bank Loan is to be paid off out of the new money.*

(viii) *The reduction of Capital and the Reserves are to be applied in eliminating the fictitious assets (including the whole of Goodwill), any balance to be used in writing down the Land, Buildings, Plant and Machinery and the Investments* pro rata.

You are required—

(*a*) *To give the Journal entries recording the reduction and reorganization.*

(*b*) *To give the resulting summarized Balance Sheet on* 1st *April.*

Assume that the money due under (v) *and* (vii) *is received and paid on* 31st *March, and the shares in* (v) *are placed in the Trust's name that day.*

Ignore all fractions of Shares and Debentures.

JOURNAL

		£	£
	6% Convertible Debentures Account *Dr.*	636,700	
	To 6½% Preference Share Capital Account		318,350
	„ New Ordinary Share Capital Account		95,505
	„ Non-convertible 6% Debentures Account		222,845
	Exchange of each £100 Debentures for £35 Non-convertible 6% Debentures, 100 6½% Preference Shares of 10s. each and 90 Ordinary Shares of 3s. 4d. each in accordance with scheme of reduction and re-organization approved by Order of Court of this day.		

JOURNAL—(*contd.*)

	£	£
6% Preference Share Capital Acct. *Dr.*	421,840	
Ordinary Share Capital Account . *Dr.*	819,330	
To 6½% Preference Share Capital Account		210,920
,, New Ordinary Share Capital Account		189,285
,, Capital Reduction Account .		840,965
Writing down each 6% Preference Share from 20s. to 12s. 6d., represented as to 10s. by 6½% Preference Shares and 2s 6d by Ordinary Shares and each Ordinary Share from 20s. to 3s. 4d., under above scheme.		
6½% Preference Share Capital Account (10s. shares) . . . . *Dr.*	529,270	
To 6½% Preference Shares Capital Account (£1 shares) . .		529,270
Consolidation of each two 10s. shares into one £1 share under above scheme.		
Ordinary Share Capital Account (3s. 4d. shares) . . . . . . *Dr.*	284,790	
To Ordinary Share Capital Account (£1 shares)		284,790
Consolidation of each six 3s. 4d. shares into one £1 share under above scheme.		
Cash . . . . . . *Dr.*	375,000	
To Application and Allotment Account		375,000
Application from Argentum Trust, Limited, for 375,000 Ordinary Shares, paid in full.		
Application and Allotment Account *Dr.*	375,000	
To Ordinary Share Capital Account		375,000
Allotment of above shares.		
Bank Loan . . . . . *Dr.*	100,000	
To Cash		100,000
Repayment of loan.		

JOURNAL—(*contd.*)

		£	£
	Capital Reduction Account . *Dr.*	840,965	
	Reserves . . . . . . *Dr.*	68,600	
	To Profit and Loss Account . .		230,044
	,, Discount and Expenses on issue of Debentures Account . .		31,735
	,, Goodwill		379,468
	,, Land, Buildings, Plant and Machinery Account. . .		188,640
	,, Investments Account . .		79,678
	Amounts written off under scheme of reduction.		

MERLEWOOD MANUFACTURING COMPANY, LIMITED

SUMMARIZED BALANCE SHEET AS AT 1ST APRIL

	£	£		£
Issued Capital: (reduced by Order of Court dated from 421,840 6% Preference Shares of £1 each and 819,330 Ordinary Shares of £1 each, fully paid.)			Land, Buildings, Plant and Machinery at cost less depreciation and amounts written off on reduction of capital .	754,560
6½% Preference Shares £1 each fully paid		529,270	Stock and Work-in-Progress .	318,724
Ordinary Shares, £1 each, fully paid) .		659,790	Debtors . . .	180,391
5½% Sinking Fund 1st Mortgage Debentures	315,000		Investments . . .	318,712
Interest accrued thereon, *less* tax .	5,969		Cash	275,000
		320,969		
Non-convertible 6% Debentures[1] . .		222,845		
Interest accrued on 6% Debentures . .		15,136		
Creditors . . .		99,377		
		£1,847,387		£1,847,387

[1] If preferred, an explanation of the reduction in this item can be added, but this is not essential.

CHAPTER VII

REDEEMABLE PREFERENCE SHARES

A COMPANY, if authorized by its Articles, can issue preference shares which carry the power and right of redemption, under Section 46 of the Companies Act, 1929. The provisions governing such shares are as follows—

(1) The shares cannot be redeemed until fully paid.

(2) The shares can be redeemed only out of profits otherwise available for dividend, *or* out of the proceeds of a fresh issue of shares made for the purpose.

(3) Where the shares are redeemed out of profits, there must be transferred out of profits to a "Capital Redemption Reserve Fund" a sum equal to the amount applied in redeeming the shares.

(4) If shares are redeemed out of the proceeds of a fresh issue, any premium payable on the redemption must be provided out of profits before the redemption.

(5) The Capital Redemption Reserve Fund may be reduced in the same way as share capital (i.e. by special resolution and sanction of the Court). If a fresh issue of shares is made after the creation of a Capital Redemption Reserve Fund, the fund may be used, up to the nominal value of the new shares issued, in paying up Bonus Shares.

(6) Every Balance Sheet must include a statement showing what part of the issued capital consists of Redeemable Preference Shares, and the date on or before which these shares are, or are liable, to be redeemed.

(7) Notice of the redemption must be given to the Registrar of Companies within one month of the redemption.

(8) Where a fresh issue of shares is made to provide the funds for the redemption, no stamp duty is payable on any temporary increase of the issue over the authorized share capital provided the redemption takes place within one month of the issue.

Illustrations. (1) *A company made an issue of 20,000 £1 6 per cent Redeemable Preference Shares.*

Under powers given in the Articles and the terms of issue, the directors decided to issue 20,000 5 per cent Preference Shares and with the proceeds to redeem the 6 per cent shares at a premium of 10 per cent. The new issue was payable as to 5s. on application and the balance on allotment, and was fully subscribed.

Show the Journal entries involved, including cash transactions.

JOURNAL

		£	£
	Cash . . . . . . *Dr.*	5,000	
	To Application and Allotment Account		5,000
	5s. per share on application for 20,000 5% Preference Shares.		
	Application and Allotment Account *Dr.*	20,000	
	To 5% Preference Share Capital Account		20,000
	Amount due on application and allotment (£1 per share) on 20,000 shares allotted this day.		
	Cash . . . . . . *Dr.*	15,000	
	To Application and Allotment Account		15,000
	Allotment money.		
	Profit and Loss Account . . *Dr.*	2,000	
	6% Redeemable Preference Share Capital Account . . . . *Dr.*	20,000	
	To Sundry Members . . .		22,000
	Transfer of 20,000 shares for redemption at a premium of 10%.		
	Sundry Members . . . *Dr.*	22,000	
	To Cash		22,000
	Redemption of 20,000 6% Redeemable Preference Shares at a premium of 10%.		

(2) *A company had issued 20,000 Ordinary Shares of £1 each, 5s. paid, and 20,000 5 per cent Redeemable Preference Shares of £1 each, fully paid, redeemable at par. On the date when the shares were*

redeemable, the company had a Reserve of £15,000 and a Profit and Loss Account credit balance of £8,000. Two months after the redemption the company issued 15,000 Ordinary Shares of £1 each, payable as to 1s. on application and 4s. on allotment. No further calls were made. The company then allotted bonus shares (ordinary) to the amount permitted by Section 46 of the Companies Act, 1929. Record the above by Ledger Accounts.

5% REDEEMABLE PREFERENCE SHARE CAPITAL ACCOUNT

	£		£
To Cash . . . . (1)	20,000	By Balance b/f	20,000

ORDINARY SHARE CAPITAL ACCOUNT

			£
..		By Balance b/f	20,000
		" Application and Allotment Account . . . (5)	3,750
		" Capital Redemption Reserve Fund . . (7)	15,000

RESERVE ACCOUNT

	£		£
To Profit and Loss Account . (2)	15,000	By Balance b/f	15,000

PROFIT AND LOSS ACCOUNT

	£		£
To Capital Redemption Reserve Fund . . . . (3)	20,000	By Balance b/f	8,000
		" Reserve Account . . (2)	15,000

CAPITAL REDEMPTION RESERVE FUND

	£		£
To Ordinary Share Capital Account—Bonus Shares . (7)	15,000	By Profit and Loss Account (3)	20,000

ORDINARY SHARE APPLICATION AND ALLOTMENT ACCOUNT

	£		£
To Ordinary Share Capital Account . . (5)	3,750	By Cash—Application Money (4)	750
		,, do Allotment Money (6)	3,000
	£3,750		£3,750

Notes. (1) The order of the entries involved by the transactions is indicated in each account by the numbers in brackets.

(2) Since £20,000 shares are redeemed at par, a like amount must be transferred out of profits available for dividend to the Capital Redemption Reserve Fund.

(3) On the issue of new shares, the Fund can be utilized, *to the nominal value of the new shares issued,* in paying up bonus shares. £15,000 is the amount so available. It should be noted that there is no provision that the new shares be fully called or paid up before the bonus shares are allotted. The principle apparently involved is that the company shall be in a position to call up the money. The balance of the Fund must remain as a "liability."

(4) It is not considered necessary to open a "Bonus Account," since the issue has statutory authority.

(3) *A company had an issue of 40,000 £1 5½ per cent Redeemable Preference Shares, fully paid, which were redeemable at a premium of 10 per cent. The undistributed profits on the date of redemption amounted to £46,000. Show the Journal entries required to redeem the shares and comply with Section 46 of the Companies Act, 1929. Journalize Cash.*

JOURNAL

		£	£
	Redeemable Preference Share Capital Account . . . . . *Dr.*	40,000	
	Premium on redemption of Shares Account . . . . . *Dr.*	4,000	
	To Sundry Members Account .		44,000
	Transfer of amounts due.		
	Sundry Members Account . . *Dr.*	44,000	
	To Cash		44,000
	Redemption of £40,000 5½% Redeemable Preference Shares at a premium of 10%.		

JOURNAL—(*contd.*)

		£	£
A	Profit and Loss Account . . *Dr.* To Capital Redemption Reserve Fund . . . . . Transfer of amount applied in redeeming shares	44,000	44,000
B	Profit and Loss Account . . *Dr.* To Capital Redemption Reserve Fund . . . . . „ Premium on redemption of Shares Account . . . Transfer of amount applied in redeeming shares, and premium written off.	44,000	40,000 4,000

Note. Entries A and B, of course, are not *both* necessary; one or other is correct; which complies with the meaning of the Act, however, is not clear. Accountancy principles are satisfied by B, and vitiated by A, inasmuch as in the case of A, the premium has either to be treated as an "asset" or written off to Profit and Loss Account, the latter treatment resulting in a double provision for the premium. The amount *applied in redeeming* appears to be the nominal value, the premium being an additional payment.

Until judicial authority is available, however, examination candidates will be well advised to add a note on the point similar to that given here.

Where a company has an issue of redeemable preference shares, it may find it advisable to build up a sinking fund in order to ensure that the necessary funds are available when required.

The following are representative examination questions—

Illustrations. (1) *On* 1st *January,* 1934, *a limited company issued* £40,000 *Redeemable Preference Shares at par, redeemable at the option of the company on or after* 31st *December,* 1935, *in whole*

or in part. Redemptions were made out of profits as follows—

31st December, 1935, £8,000; 31st December, 1936, £12,000.

On 31st January, 1938, the company made an issue of £50,000 Ordinary Shares, such issue being partly for the purposes of redemption, and out of the proceeds the remaining Redeemable Preference Shares were redeemed.

Show the Ledger entries recording these transactions, and show also the items relating thereto which would appear in the Balance Sheets at 31st December, 1934, 1935, 1936, and 1938.

REDEEMABLE PREFERENCE SHARE CAPITAL ACCOUNT

1935		£	1934		£
Dec. 31	To Cash	8,000	Jan. 1	By Application, Allotment and Call Accounts	40,000
	„ Balance, c/d	32,000			
		£40,000			£40,000
1936			1936		
Dec. 31	To Cash	12,000	Jan. 1	By Balance, b/d	32,000
	„ Balance, c/d	20,000			
		£32,000			£32,000
1938			1937		
Jan. 31	To Cash	£20,000	Jan 1	By Balance, b/d	£20,000

CAPITAL REDEMPTION RESERVE FUND

1938		£	1935		£
Jan. 31	To Balance, c/f	20,000	Dec. 31	By Profit and Loss Account	8,000
			1936		
			Dec. 31	By Profit and Loss Account	12,000

ORDINARY SHARE CAPITAL ACCOUNT

			1938		£
			Jan. 31	By Application, Allotment and Call Accounts	50,000

EXTRACTS FROM BALANCE SHEETS

AT 31ST DECEMBER, 1934	
Capital Issued—	£
£40,000 Redeemable Preference Shares, fully paid .	40,000
Redeemable at the option of the company on or after 31st December, 1935, in whole or in part.	
AT 31ST DECEMBER, 1935	
Capital Issued—	£
£32,000 Redeemable Preference Shares, fully paid .	32,000
Redeemable at the option of the company at any time in whole or in part.	
Capital Redemption Reserve Fund	8,000
AT 31ST DECEMBER, 1936	
Capital Issued—	£
£20,000 Redeemable Preference Shares, fully paid .	20,000
Redeemable at the option of the company at any time in whole or in part.	
Capital Redemption Reserve Fund	20,000
AT 31ST DECEMBER, 1938	
Capital Issued—	£
£50,000 Ordinary Shares, fully paid. . . .	50,000
Capital Redemption Reserve Fund	20,000

(2) *A company, in a series of operations—*

(i) *Issues at par for cash* 200,000 *Redeemable Preference Shares of* £1 *each, redeemable at a premium of* 1s. *per share.*

(ii) *Redeems* 100,000 *of the Redeemable Preference Shares out of the profits of the company.*

(iii) *Issues at par for cash* 200,000 *Ordinary Shares of* £1 *each and, out of the proceeds, redeems the balance of the Redeemable Preference Shares.*

Journalize these transactions, including those relating to cash.

JOURNAL

		£	£
	Cash . . . . . . *Dr.*	200,000	
	To Redeemable Preference Share Capital Account . . .		200,000
	Issue for cash at par of 200,000 Redeemable Preference Shares of £1 each, redeemable at a premium of 1s. per share.		

JOURNAL—(*contd.*)

		£	£
	Redeemable Preference Share Capital Account . . . . . *Dr.*	100,000	
	Premium on Redemption of Redeemable Preference Shares Account *Dr.*	5,000	
	To Sundry Members . . .		105,000
	Transfer of amounts due on redemption of 100,000 Redeemable Preference Shares.		
	Sundry Members . . . . *Dr.*	105,000	
	To Cash		105,000
	Redemption of 100,000 Redeemable Preference Shares at a premium of 1s. per share.		
	Profit and Loss Account . . *Dr.*	100,000	
	To Capital Redemption Reserve Fund		100,000
	Transfer of amount applied in redeeming 100,000 Redeemable Preference Shares in compliance with Section 46, Companies Act, 1929.		
	Cash . . . . . . *Dr.*	200,000	
	To Ordinary Share Capital Account		200,000
	Issue for cash at par of 200,000 Ordinary Shares of £1 each.		
	Redeemable Preference Share Capital Account . . . . . *Dr.*	100,000	
	Premium on Redemption of Redeemable Preference Shares Account *Dr.*	5,000	
	To Sundry Members . . .		105,000
	Transfer of amounts due on redemption of 100,000 Redeemable Preference Shares.		
	Sundry Members . . . . *Dr.*	105,000	
	To Cash		105,000
	Redemption of 100,000 Redeemable Preference Shares at a premium of 1s. per share.		
	Profit and Loss Account . . *Dr.*	10,000	
	To Premium on Redemption of Redeemable Preference Shares Account		10,000
	Premium written off.		

Notes. (1) Some authorities consider that the "amount applied in redeeming the shares" required to be transferred to the Capital Redemption Reserve Fund must include the premium on the redemption. If this is the correct interpretation, £105,000 must be transferred, and the £5,000 premium could remain as a fictitious asset.

(2) The premium on the shares redeemed out of the proceeds of the new issue must be written off to Profit and Loss Account (S. 46). Since new shares have been issued to an amount equal to the Preference Shares which have been redeemed out of profits, the Capital Redemption Reserve Fund may now be applied in issuing fully-paid bonus shares to the members (Section 46 (5), Companies Act, 1929).

(3) The cash transactions would not, in practice, be journalized, and the issue of shares would be passed through Application, Allotment, and Call Accounts.

CHAPTER VIII

RECORDING TRANSACTIONS

BOOKS and Accounts—Statutory Books—Final Accounts—Balance Sheet

EVERY company must cause to be kept proper books of account with respect to—

(*a*) all sums of money received and expended by the company, and the matters in respect of which the receipt and purchase takes place;

(*b*) all sales and purchases of goods by the company,

(*c*) the assets and liabilities of the company.

The books must be kept at the registered office or at such other place as the directors think fit, and at all times be open to inspection by the directors. (S. 122.)

It is also necessary to keep stock sheets, since Section 274 imposes penalties on the directors in a winding-up if, in the two years preceding the commencement of the winding-up, there have not been kept such books or accounts as are necessary to exhibit and explain the transactions and financial position of the trade or business of the company, including books containing entries from day to day in sufficient detail of all cash received and paid, and where the trade or business involves dealings in goods, statements of the annual stock-takings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

From the above details, it is seen that the company must keep adequate books of account. The nature of the business will dictate what these books

shall be, but they must include cash book(s), purchases and sales day books and personal ledgers, in the normal case. It is not necessary to describe the functions of these books in this work.

The directors must at some date not later than eighteen months after the incorporation of the company and subsequently at least once in every calendar year lay before the company in general meeting a Profit and Loss Account or, in the case of a company not trading for profit, an Income and Expenditure Account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months, or in the case of a company carrying on business or having interests abroad, by more than twelve months. The Board of Trade, if for any special reason they think fit so to do, may, in the case of any company, extend the period of eighteen months, and in the case of any company and with respect to any year extend the periods of nine and twelve months.

BALANCE SHEET

The directors must also cause to be made out in every calendar year, and to be laid before the company in general meeting, a Balance Sheet as at the date to which the Profit and Loss, or the Income and Expenditure, Account is made up.

There must be attached to every such Balance Sheet—

(i) A report by the directors with respect to the state of the company's affairs;

(ii) The amount, if any, which they recommend should be paid by way of dividend; and

(iii) The amount, if any, which they propose to carry to the Reserve Fund, General Reserve or Reserve Account shown specifically on the Balance Sheet, or to a Reserve Fund, General Reserve or Reserve Account to be shown specifically on a subsequent Balance Sheet. (S. 123.)

The Act requires that the Balance Sheet so placed before the General Meeting shall disclose certain information. Some of the provisions require information on the "accounts," i.e. the Balance Sheet or the Profit and Loss (or Income and Expenditure) Account, or a note must give the information.

It should be noted that the legislature hesitates to impose a statutory form of Balance Sheet or accounts; it is left to prudent business men to use their honest discretion; but the Act lays down a minimum which must be disclosed. Professional practice is usually, and should be always, in advance of the law on such matters, and well drawn up Balance Sheets and Profit and Loss Accounts give much more than the minimum information required by law.

A Balance Sheet should show a true and correct view of the state of the company's affairs, and any tendency to minimize detail will obscure the position so as to make the statement of little value to the members.

The following are the requirements laid down in the Act regarding the Balance Sheet and accounts laid before the company in general meeting—

(1) The Balance Sheet must contain a summary of the authorized and issued share capital, the liabilities and assets,

with such particulars as are necessary to disclose the general nature of such assets and liabilities, distinguishing between the amounts respectively of the fixed and floating assets, and stating how the values of the fixed assets have been arrived at. (S. 124.)

(2) The Balance Sheet must show under separate headings (so far as they have not been written off)—

(*a*) the preliminary expenses;

(*b*) expenses incurred in connexion with any issue of shares or debentures;

(*c*) the amount of the goodwill and of any patents or trade-marks, if such items are shown separately or are ascertainable from the books of the company, from any contract for the sale or purchase of any property acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of such contract or the conveyance of such property. (S. 124.)

(*d*) particulars of the discount allowed upon the issue of shares. (S. 47.)

(*e*) commission paid in respect of any shares or debentures or discount allowed in respect of any debentures. (S. 44.)

(3) Any redeemed debentures available for reissue must be disclosed on the Balance Sheet. (S. 75.)

(4) The Balance Sheet must include under separate headings the aggregate amount of any outstanding loans made under the following provisions of Section 45—

(*a*) money provided by the company in accordance with any scheme for the time being in force for the purchase by trustees of fully-paid shares in the company to be held by or for the benefit of employees, including any director holding a salaried employment or office; and

(*b*) loans made by the company to persons other than directors bona fide in the employment of the company with a view to enabling those persons to purchase fully-paid shares to be held by themselves by way of beneficial ownership.

(5) The Balance Sheet must contain a statement specifying what part of the issued capital consists of redeemable preference shares (if these have been issued), and the date on or before which those shares are, or are to be liable, to be redeemed. (S. 46.)

(6) If any liability of the company is secured, otherwise than by operation of law, on any assets of the company, the Balance Sheet must include a statement that the liability is

so secured, but the particular assets involved need not be specified. (S. 124.)

(7) Where a company has issued shares on which it is empowered by Section 54 (see Chapter IX) to pay interest out of capital, the accounts must show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate. (S. 54.)

(8) The accounts must contain particulars showing—

(*a*) the amount of any loans which during the period to which the accounts relate have been made either by the company or by any other person under a guarantee from or on a security provided by the company to any director or officer of the company, including any such loans which were repaid during the said period; and

(*b*) the amount of any loans made in manner aforesaid to any director or officer at any time before the period aforesaid and outstanding at the expiration thereof; and

(*c*) the total of the amount paid to the directors as remuneration for their services, inclusive of all fees, percentages, or other emoluments, paid to or receivable by them by or from the company or by or from any subsidiary company.

The provisions regarding loans do not apply—

(*a*) in the case of a company the ordinary business of which includes the lending of money, to a loan made by the company in the ordinary course of its business; or

(*b*) to a loan made by the company to any employee of the company if the loan does not exceed £2,000 and is certified by the directors to have been made in accordance with any practice adopted or about to be adopted by the company with respect to loans to its employees.

If the directors do not include in their Balance Sheet the above particulars, the auditor must include a statement of them in his report, so far as he is reasonably able to do so.

Particulars need not be given of any remuneration paid to a managing director, nor of sums other than directors' fees paid to a director who holds any salaried office in the company. The term "directors' fees" include allowances or perquisites of office. (S. 128.)

(9) The Balance Sheet must set out the aggregate holding in, and the amounts owing to and the indebtedness of subsidiary companies, separately from all other assets or liabilities respectively (S. 125). As to this and to the statement required to be annexed to the Balance Sheet of a holding company, see Chapter XIV.

The Act is silent as to the form of and information to be contained in the Profit and Loss Account (or Income and Expenditure Account, if that is the appropriate form), except that this account may be the logical place in which to give certain of the information required to be shown in "the accounts," e.g. directors' fees. It has been a common practice to give little information in the published Profit and Loss Account, but enlightened opinion to-day tends to give as much information as possible, having regard to the company's interests. An inspection of published accounts will disclose a vast variety of practice in this respect.

Naturally, the Balance Sheet and Profit and Loss Account prepared for submission to the directors will disclose a great deal of detail which will not be shown in the accounts sent to the members. The suppression of information should, however, be the minimum consistent with the company's interests.

STATISTICAL BOOKS

In addition to the books of account, every company must keep a Register of Members, Register of Charges, Register of Directors and Managers, and Minute Books of directors' and members' meetings. There must be included in the Register of Members the Annual Return, a copy of which

is delivered to the Registrar of Companies for filing. As none of these books directly affects the accounting, it is not considered necessary to describe them here.

FINAL ACCOUNTS

The preparation of the final accounts of a company does not depart in any way from general principles, provided that care is taken to comply with the Act and to deal correctly with the following items—

Capital. The authorized and issued capital must be separately stated. Where calls are in arrear, the amount called up should be shown with the calls in arrear deducted inset, only the amount paid or credited as paid being extended. The different classes of shares must be stated separately. Calls in advance are added.

If the Articles provide for interest being charged on calls in arrear, it is sometimes considered advisable not to take credit for the interest until received. Interest paid on calls in advance will be charged in the Profit and Loss Account. The Articles must be inspected as to rates authorized, etc. Normally, the Articles provide that amounts in arrear or paid in advance on shares shall not be taken into account in calculating dividends so long as interest is charged or allowed thereon, i.e. dividends are normally in such cases paid on the amount called up. But where no interest is taken into account, the Articles may provide for dividends being paid on the amount paid up.

Debentures. The gross amount outstanding must

appear as a liability. If any debentures have been issued to bankers or others as additional security for advances, the debentures so issued will not appear in the accounts, as they are contingent liabilities. In the Balance Sheet a note of the issue should appear under the liability in respect of which they have been issued.

Accrued interest should be computed to the date of the Balance Sheet and added, inset, to the debentures, the total being extended.

Profit and Loss Account. The Profit and Loss Account balance carried forward will appear as a liability (or on the assets side of the Balance Sheet if a debit balance).

Care must be taken to see that the groupings of assets and liabilities do not obscure the general nature of any asset or liability.

PAYMENTS TO DIRECTORS

The easiest method of showing the directors' fees is by insetting the gross amount paid to directors (including fees paid by subsidiary companies) and deducting the amount paid by subsidiary companies, so that the amount extended is the amount paid by the company itself.

It should be particularly noted that no fees paid to the managing director of a company need be shown, even if he is also an ordinary director of subsidiary companies, and it is usual to include his remuneration in salaries. If, however, an ordinary director of a holding company is managing director of a subsidiary company, the accounts of the holding company must include all his remuneration in the directors' fees item.

Loans to directors and officers are best shown in the Balance Sheet as follows—

	£
Loans to directors—	
Amounts outstanding at beginning of year . .	
Add: Amounts advanced during year . .	
Deduct: Amounts repaid during year . .	

The amount extended is then, of course, the loans outstanding.

PREPARATION OF BALANCE SHEET

The Balance Sheet is not an account in the books, but a classified summary of the balances remaining in a set of books kept by double entry, after the transfer of the nominal balances to the Profit and Loss Account, and including the balance of that account. It is accordingly a statement of the company's affairs on a given date, showing its position as a going concern.

It is convenient to regard the Balance Sheet as a statement rendered to the proprietors by the executive officers, showing on the "Liabilities" side the money or money's worth had and received and to be accounted for by the executive to the proprietors and creditors, and on the "assets" side how they account therefor.

Being a statement, the Balance Sheet must be headed as "Balance Sheet *as at*" the given date, not for a period, and it is better practice not to head it "Dr." and "Cr." nor to use the prefixes "To" and "By," although many eminent firms of accountants still employ this method, treating the Balance Sheet as an account, not in the books, but rendered by the executive. Where the latter

practice is employed, it is thought that a complete heading should be employed, e.g. "The Directors of X Ltd. in Account with the Members," but this is never done.

The "sides" of the Balance Sheet are headed "Liabilities" and "Assets," although there are included many credit items which are not liabilities and many debit items that are not assets in the true sense. In order to meet these criticisms, it is often found that the headings used are "Share Capital and Liabilities" and "Assets and other Debit Balances" respectively.

The familiar form of Balance Sheet is sometimes criticized on the grounds that it is not at all clear to laymen, and accordingly, the following form has been suggested, and adopted by many concerns—

X LTD.

BALANCE SHEET AS AT 31ST DECEMBER

Assets		£	£
Fixed Assets—			
Freehold Property, at cost		143,240	
Less Amount written off on revaluation 30th September		25,240	
			118,000
Leasehold Properties, at cost		85,000	
Less Depreciation to beginning of year . . .	£51,000		
Depreciation for year .	1,700		
		52,700	
			32,300
Furniture and Fittings at cost less depreciation previously written off . . .		1,400	
Less Depreciation for year . . .		140	
			1,260
Plant and Machinery, at cost less depreciation previously written off		89,456	
Less Depreciation for year . . .		6,710	
			82,746
Carried Forward			234,306

X LTD.—(*contd.*)

BALANCE SHEET AS AT 31ST DECEMBER

		£	£
Brought Forward			234,306
Sinking Fund Investments at cost			32,345
Investments in shares of Subsidiary Companies, at cost		250,000	
Less provision for losses		14,000	
			236,000
Total Fixed Assets			£502,651
Deduct:			
Mortgages on Freehold Property		80,000	
Interest Accrued thereon		1,600	
			81,600
Free Fixed Assets			£421,051
Floating and Liquid Assets—			
Stock-in-Trade		39,425	
Subsidiary Companies Current Accounts		28,972	
Sundry Debtors	£56,380		
Less Reserve for Bad and Doubtful Debts	2,819		
		53,561	
Loans to Directors and Officers—			
As at beginning of year	£3,500		
Advances during year	2,000		
	5,500		
Less Repaid during year	5,000		
		500	
Balance at Bank and Cash in Hand		24,078	
		146,536	
Deduct: Sundry Creditors		49,711	
Working Capital			96,825
Excess of Assets over Liabilities and Specific Provisions			£517,876

Representing Capital and Undistributed Profits as follows—

		£	£
Share Capital—			
Authorized:			
200,000 6% Preference Shares of £1 each	£200,000		
3,000,000 Ordinary Shares of 2s. each	300,000		
	£500,000		

		£	£
Share Capital—(*contd.*)—			
Issued:			
200,000 6% Preference Shares of £1 each, fully paid		200,000	
2,000,000 Ordinary Shares of 2s. each, 1s. 6d. called . .	£150,000		
Less Calls in Arrear . .	75		
	149,925		
Add Calls in Advance .	420		
		150,345	
			350,345
General Reserves			110,000
Sinking Fund			32,345
Profit and Loss Account—			
Balance at 1st January		30,278	
Net Profit for Year . . .	£49,644		
Less Transfer to Sinking Fund .	2,496		
		47,148	
		77,426	
Preference Dividends .	12,000		
Ordinary do. . .	15,000		
		27,000	
		50,426	
Deduct: Loss on Revaluation of Freehold Property		25,240	25,186
			£517,876

The comparative figures for the previous year are a very valuable addition to a Balance Sheet.

In view of the fact that many items in a Balance Sheet can only be approximate amounts, e.g. the depreciation written off is a matter of opinion, and so is the value of stock to a certain extent, it has been suggested that every item should be stated only to the nearest £, as this is said, by the supporters of this idea, to make the Balance Sheet easier to read, and indicates too that it is not necessarily an absolutely exact statement of affairs.

Following the criticism of the lay-out of Balance Sheets, similar comments have been applied to the

Profit and Loss Account, and it has been suggested that the latter would be easier to follow if set out as follows—

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER

Last Year				
£	£		£	£
	211,443	Sales (less Returns)		223,618
	144,032	*Deduct:* Cost of Sales		152,497
	67,411	Gross Trading Profit		71,121
		Deduct:		
28,089		Administration Expenses[1]	27,991	
17,989		Selling Expenses[1]	18,615	
1,100		Directors' Fees	1,200	
584	47,762	Depreciation	543	48,349
	19,649	Net Trading Profit		22,772
		Add: Non-trading income—		
1,500		Dividends from Subsidiary Companies	1,500	
950		Interest and Dividends on Investments	650	
50		Transfer fees	29	
2,500			2,179	
—		*Less* Non-trading expenses[1]	100	
	2,500			2,079
	22,149	Net Income for Year		24,851
		Add:		
	15,625	Amount brought forward from last year		17,774
	37,774			42,625
		Deduct:		
16,000		Dividends paid	18,000	
4,000		Transfer to Reserve	5,000	
	20,000			23,000
	£17,774	Balance carried forward		£19,625

[1] These items would preferably be shown in greater detail.

The addition of the column for the figures of the previous year enhances the usefulness of the statement considerably, enabling ready comparison to be effected.

The following is an even more "advanced" method of the presentation of accounts to the shareholders—

X Y Z LTD.

PROFIT AND LOSS ACCOUNT

	Year ended 30th Sept., 1936		*Year ended 30th Sept., 1935*	
	£	£	£	£
Profit from Trading, Dividends on Investments, etc., including the Profits of Subsidiary Companies to the extent of the Dividends declared, and after making provision for Income-tax and Contingencies		272,244		*149,326*
Deduct:				
Depreciation	25,000		*14,000*	
Directors' Fees	3,250		*3,042*	
Amount Written off House Property	184		*475*	
		28,434		*17,517*
Net Profit for the Year		243,810		*131,809*
Add Balance at previous 30th Sept.	148,013		*120,421*	
Less Appropriation and Dividends voted at previous Annual Meeting	90,702		*69,803*	
		57,311		*50,618*
		301,121		*182,427*
Deduct Dividends of—				
4% on the 8% Cum. First Pref. Shares for the half-year ended 31st March	6,829		*6,829*	
3% on the 6% Cum. Second Pref. Shares for the half-year ended 31st March	15,000		*15,000*	
Also Interim Dividends of—				
6% Actual on the Ord. Shares on account of the Year ended 30th September	9,000		*9,000*	
6% Actual on the "A" Ord. Shares on account of the Year ended 30th September	4,972		*3,585*	
		35,801		*34,414*
		£265,320		*£148,013*

Note. The amount of Fees paid to Directors in respect of the year ended 30th September, 1936, as required to be stated by Section 128 (*c*) of the Companies Act, 1929, is £2,000.

X Y
Y Z, *Directors.*

X Y Z LTD.

Balance Sheet, 30th September, 1936
(With Comparative Figures as at 30th September, 1935)

	1936		1935	
Authorized Capital:	£	£	£	£
8% Cum. First Pref. Shares of £1 each	200,000		200,000	
6% Cum. Second Pref. Shares of £1 each . . .	500,000		500,000	
		700,000		700,000
Ord Shares of 5s each . .	150,000		150,000	
"A" Ord. Shares of 5s. each .	150,000		150,000	
		300,000		300,000
		£1,000,000		£1,000,000
Issued Capital and Reserves: (All Shares Fully Paid)				
8% Cum. First Pref. Shares .	170,725		170,725	
6% Cum. Second Pref. Shares.	500,000		500,000	
		670,725		670,725
Ord. Shares	150,000		150,000	
"A" Ord. Shares . . .	91,294		67,633	
		241,294		217,633
Total Capital . .		912,019		888,358
Capital Reserve	233,807		212,233	
General Reserve	180,000		140,000	
Profit and Loss Account .	265,320		148,013	
		679,127		500,246
		£1,591,146		£1,388,604
Represented by:				
Property, Plant, etc. . .		346,649		350,659
Subsidiary and Associated Companies		544,958		638,473
Net Liquid Assets . .		699,539		399,472
		£1,591,146		£1,388,604
Composed as under:				
Freehold Land and Premises, Plant, Tools, Furniture, Fixtures, etc.:				
At Cost *less* Sales and Depreciation as at previous 30th September . . .	350,659		355,299	
Add Additions *less* Sales during Year	20,990		9,360	
		371,649		364,659
Deduct Depreciation Written Off		25,000		14,000
		£346,649		£350,659

BALANCE SHEET—(*contd.*)

	1936		1935	
Subsidiary and Associated Companies:	£	£	£	£
Subsidiary Companies				
Shares at Cost, *less* Amounts Written Off . . .	528,958		528,617	
Current Accounts and Advances, *less* Amounts Written Off	86,878		123,492	
	615,836		652,109	
Deduct: Amounts due to Subsidiary Companies . .	81,817		21,849	
		534,019		630,260
Associated Companies				
Shares at Cost, *less* Amounts Written Off . . .	8,293		8,213	
Current Accounts . .	2,646		—	
		10,939		8,213
		£544,958		£638,473
Current Assets:				
Cash at Bankers and in Hand	358,195		157,731	
Sundry Debtors and Prepayments	315,094		215,851	
Stock-in-Trade and Work-in-Progress, at Cost, or under, as certified by the Company's Officials . . .	144,266		143,445	
Investments at or under Market Value	4,517		4,642	
	822,072		521,669	
Deduct: Contingency Reserve	7,484		7,584	
		814,588		514,085
Less—				
Current Liabilities:				
Sundry Creditors and Accrued Charges		115,049		114,613
Net Liquid Assets . .		£699,539		£399,472

There are Contingent Liabilities in respect of (*a*) Bills under Discount, £9,523; (*b*) Uncalled Capital in respect of Investments, £6,773; (*c*) the Company's Guarantee of the Preference Dividend of the B Co. Ltd., £9,531.

X Y } *Directors.*
Y Z }

REPORT OF THE AUDITOR TO THE MEMBERS OF X Y, LTD.

We have audited the foregoing Balance Sheet as at 30th September, 1936, with the Books and Accounts of the Company, and have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at that date, according to the best of our information and the explanations given to us and as shown by the Books of the Company.

C. H. ECKER & CO.,
Chartered Accountants, Auditors.

LONDON, 10*th November*, 1936.

The following are representative examination questions—

Illustrations. (1) *On 30th June, 1936, the follow-items appeared on the liabilities side of the Balance Sheet of a limited company—*

Reserve Fund	£20,000
Profit and Loss Account	£12,500

while among the assets there were—

Investments representing the Reserve Fund (at cost)	£20,000
Branch Premises (at cost)	£8,000

During the year ended 30th June, 1937, the investments were sold for £19,500 and the Branch Premises for £10,000. The trading for that year resulted in a loss of £13,200.

Explain what entries would be required in the company's books in view of the foregoing facts.

The following entries would be required in the company's books—

(i) Transfer the loss on realization of the Reserve Fund Investments, £500, to the debit of the Reserve Fund.

(ii) Transfer the balance of the Reserve Fund, £19,500, to General Reserve.

(iii) Transfer the capital profit made on the sale of the Branch Premises, £2,000, to Capital Reserve.

The directors would probably decide to transfer part of the General Reserve to Profit and Loss Account to extinguish the debit balance, £700.

(2) *The Authorized Capital of Blank Ltd. is £600,000, divided into 300,000 7 per cent Cumulative Preference Shares of £1 each and 300,000 Ordinary Shares of £1 each.*

The Trial Balance as on 31st December, 1934, is as follows—

Debits	£	*Credits*	£
Investments at Cost—		*6 per cent 1st Mortgage Debentures secured on Freeholds*	100,000
A Ltd., 50,000 Ord. Shares of £1 fully paid	50,000	*Trade Creditors*	56,950
B Ltd., 650,000 Ord. Shares of 5s. each fully paid	150,000	*Shares Issued—*	
C Ltd., 20,000 Ord. Shares of £1 each 12s. 6d. paid up	10,000	*300,000 7 per cent Cumulative Preference fully paid*	300,000
Freehold Land and Buildings	200,000	*250,000 Ordinary fully paid*	250,000
Leaseholds, at cost	150,000	*Trading Account, balance*	48,600
Plant and Machinery, at cost less depreciation	75,000	*Appropriation Account, balance on 1st January, 1934*	1,505
Stock on 31st December, 1934	70,000	*Reserve for Depreciation of Leaseholds*	60,000
Trade Debtors	60,000	*Dividend from B Ltd.*	8,120
Balance at Bankers	20,000		
Debenture Interest, ½ year to 30th June, 1934, net	2,325		
Salaries	10,000		
Selling Expenses	15,000		
General Expenses	7,000		
C Ltd., Current Account, balance	300		
Income-tax Account, balance	3,000		
Ground Rent, ½ year to 30th June, 1934, net	1,550		
Directors' Fees	1,000		

The Directors decided—

(*a*) *That a reserve of 1 per cent of Trade Debtors should be provided for doubtful debts.*

(*b*) *That there should be a reserve of £1,000 for income-tax.*

(*c*) *That a reserve should be made for the proper proportion of the loss incurred by C Ltd.* (*See* (5) *below.*)

Regard should be had also to the following facts—

(1) *The issued Capital of A Ltd. is 100,000 Ordinary Shares of £1 each fully paid.*

(2) *The issued Capital of B Ltd. is 650,000 Ordinary Shares of 5s. each and 500,000 Cumulative Preference Shares of £1 each, all fully paid.*

(3) *The issued Capital of C Ltd. is 30,000 Ordinary Shares, 12s. 6d. called and paid up.*

(4) *In each of the three companies one share carries one vote and Blank Ltd. have no powers as regards the appointment of directors beyond their ordinary rights as members.*

(5) *The financial year of A Ltd., B Ltd., and C Ltd., ended on 30th September, 1934, the results being: A Ltd., Loss £2,000; B Ltd., Profit £50,000; C Ltd., Loss £1,500.*

(6) *The Freehold Land and Buildings are shown in the books at a valuation dated 30th May, 1928.*

(7) *Since 1st March, 1932, when final dividends were paid in respect of the year ended 31st December, 1931, no distribution of profits has been made to the members.*

Draft the Profit and Loss Account of Blank Ltd. for the year ended 31st December, 1934, and Balance Sheet as on that date in a form to comply with the

PROFIT AND LOSS ACCOUNT
YEAR ENDED 31ST DECEMBER, 1934

	£		£
To Salaries	10,000	By Gross Profit from Trading Account	48,600
„ Directors' Fees	1,000	„ Dividend from Subsidiary Company	8,125
„ General Expenses	7,000		
„ Selling Expenses	15,000		
„ Debenture Interest	6,000		
„ Ground Rent	4,000		
„ Reserve for Doubtful Debts	600		
„ Net Profit c/d	13,125		
	£56,725		£56,725
To Reserve for Loss of Subsidiary Company	1,000	By Balance b/f	1,500
„ Income-tax	2,875	„ Net Profit b/d	13,125
„ Balance c/f	10,750		
	£14,625		£14,625

Companies Act, 1929, *and suitable for presentation at the Annual General Meeting. Show the Auditors' Report to the members, and any other statements required to be annexed to the Balance Sheet. Income-tax was* 4s. 6d. *in the* £.

BLANK LTD.

BALANCE SHEET AS AT 31ST DECEMBER, 1934

Capital and Liabilities	£	£	*Assets*	£	£
Capital—			Freehold Land and Buildings as valued on 30th May, 1928		200,000
Authorized:			Leaseholds at cost	150,000	
300,000 7% Cum. Pref. Shares of £1 each	300,000		*Less* Reserve for Depreciation	60,000	
300,000 Ord. Shares of £1 each	300,000				90,000
	£600,000		Plant and Machinery, at cost *less* depreciation		75,000
Issued:			Investments in Subsidiary Companies at cost	160,000	
300,000 7% Cum. Pref Shares of £1 each, fully paid	300,000		*Less* Reserve for Loss attributable to holdings therein	1,000	
250,000 Ord. Shares of £1 each	250,000				159,000
		550,000	Other Investments, at cost		50,000
Six per cent 1st Mortgage Debentures	100,000		Stock		70,000
Interest due thereon	3,000		Trade Debtors	60,000	
		103,000	*Less* Reserve for Doubtful Debts	600	
Trade Creditors		56,950			59,400
Expense Creditor		2,000	Amount due from Subsidiary Company		300
Income-tax Reserve		1,000	Balance at Bankers		20,000
Profit and Loss Account		10,750			
	£	723,700		£	723,700

.... } *Directors.*
....

Notes. (1) No preference dividends have been paid since that for the year to 31st December, 1931.

(2) There is a contingent liability in respect of uncalled capital of 7s. 6d. per share on 20,000 shares held in a subsidiary company.

Auditor's Report to the Members

We have audited the Balance Sheet of Blank, Ltd., as at 31st December, 1934, as above set forth. We have obtained all the information and explanations we have required, and, in our opinion, such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs, according to the best of our information and

the explanations given to us and as shown by the books of the Company.

. . . .

Chartered Accountants,
Auditors.

Statement by the Directors pursuant to Section 126 *of the Companies Act,* 1929

Profits of Subsidiary Companies have been taken into account in the above accounts to the extent of dividends received during the year. One Subsidiary Company made a loss in the year ended within the accounting period of Blank Ltd. Reserve has been made in the above accounts for the proportion of such loss attributable to the holding of Blank Ltd. in that company.

. . . . . } *Directors.*

(3) *The Authorized Capital of Providers Ltd. is* £400,000 *divided into* 200,000 6 *per cent Preference Shares of* £1 *each and* 200,000 *Ordinary Shares of* £1 *each.*

The company's trial balance as on 31*st December is as follows*—

Debits	£	*Credits*	£
Investments in A Ltd., a Subsidiary— Shares as valued by the Directors on 31*st December,* 1930	70,000	*General Reserve*	40,000
Shares acquired during year to 31*st December, at cost*	30,000	*Shares Issued— 200,000 6% Preference, fully paid*	200,000
Second Debentures, at cost	50,000	*100,000 Ordinary, fully paid*	100,000
Stock	25,000	*4% Loan, secured on Freeholds*	60,000
Ordinary Dividend for previous year	15,000	*A Ltd., Current Account, balance*	2,050
Preference Dividend for half-year to 31*st December of the previous year, net*	4,500	*Trade Creditors*	52,500
Preference Dividend for half-year to 30*th June of the current year, net*	4,500	*Gross Profit from Trading Account*	56,000
Income-tax Account, balance	7,000	*Dividend from A Ltd., Gross Amount*	10,000
Balance at Bankers	45,000	*Debenture Interest from A Ltd., Gross Amount*	2,250
Loan Interest, half-year to 30*th September of the current year, net*	900	*Reserve for depreciation of Leasehold Properties, as on* 1*st January*	15,000
Trade Debtors	70,000	*Profit and Loss Appropriation Account, Balance as on* 1*st January*	35,000
Loan to Secretary	500		
Freehold Properties, at cost	70,000		
Leasehold Properties, at cost	80,000		
Fixtures, Fittings and Furniture, at cost, less depreciation, as on 1*st January*	50,000		
Rates	5,000		
General Expenses	7,900		
Salaries and Wages	20,000		
Sinking Fund Policies, Surrender Values as on 1*st January*	15,000		
Premiums on Sinking Fund Policies	2,500		

The directors decided—

(*a*) *That a reserve of 2 per cent of Trade Debtors should be provided for doubtful debts.*

(*b*) *That depreciation of Fixtures, etc., should be provided for at* $7\frac{1}{2}$ *per cent.*

(*c*) *That there should be a reserve of £6,000 for income-tax.*

(*d*) *That the amount of £2,750 by which the surrender values of the Sinking Fund policies had increased during the year to 31st December should be included in the reserve for depreciation of Leasehold Properties.*

It is necessary to have regard also to the following facts—

(1) *The financial year of A Ltd. ended on 31st July, and the trading operations resulted in a profit. A dividend was paid on 30th November, and the amount thereof to which Providers Ltd. were entitled has been included in the figures shown in the above trial balance. No directors' fees were paid by A Ltd. The Auditors' Report is qualified in the following terms: "No provision has been made for depreciation of leasehold properties."*

(2) *Included in the item "Salaries and Wages £20,000" is the sum of £5,000 paid to the directors, of which £2,500 was paid to the Managing Director as salary.*

(3) *Included in the item "Rates £5,000" is £2,000 paid for the half-year to 31st March following.*

(4) *The interest in a Sinking Fund policy for £20,000 taken out by A Ltd. as a security for the First Debentures of that company was assigned, subject to the rights of the holders of those debentures, to Providers Ltd., who pay the annual premium.*

(5) *It is not the ordinary business of Providers Ltd. to lend money, but on 1st February a loan of £2,000 was made to a director. This sum was repaid on 1st December.*

(6) *The company had issued a Debenture for £50,000 as collateral security against a loan from the bank. On 31st December the loan had been repaid but the bank still held the debenture.*

Prepare the Profit and Loss Account of Providers Ltd. for the year ended 31st December, and Balance Sheet as on that date in a form to comply with the Companies Act, 1929, and suitable for presentation at the Annual General Meeting. Show the Auditors' Report to the members and any other statements required by the Act to be annexed to the Balance Sheet. Income-tax at 5s. in £.

PROVIDERS, LTD.

PROFIT AND LOSS ACCOUNT, YEAR ENDED 31ST DECEMBER

		£		£
To Salaries and Wages		17,500	By Gross Profit from Trading Account	56,000
„ Directors' Fees		2,500	„ Dividend from Subsidiary Company	10,000
„ General Expenses		7,900	„ Debenture Interest from Subsidiary Company	2,250
„ Rates		4,000		
„ Loan Interest		1,800		
„ Depreciation of Fixtures, Fittings and Furniture		3,750		
„ Reserve for Doubtful Debts		1,400		
„ Reserve for Depreciation of Leasehold Properties		2,500		
„ Net Profit for year, c/d		26,900		
		£68,250		£68,250
To Preference Dividends—			By Balance b/f from last year	35,000
Final last year	£6,000		„ Net Profit for year b/d	26,900
Interim this year	6,000			
		12,000		
„ Ordinary Dividend for last year		15,000		
„ Income-tax		9,700		
„ Balance, c/d		25,200		
		£61,900		£61,900

PROVIDERS, LTD.

BALANCE SHEET AS AT 31ST DECEMBER

Capital and Liabilities		£	*Assets*		£
Authorized Share Capital—			Freehold Properties, at Cost		70,000
200,000 6% Pref. Shares of £1 each		200,000	Leasehold Properties, at Cost		80,000
200,000 Ord. Shares of £1 each		200,000	Fixtures, Fittings, and Furniture, at Cost, *less* Depreciation as on 1st January	£50,000	
	£	400,000	*Less* Depreciation for year	3,750	46,250
Issued Share Capital— 200,000 6% Pref. Shares of £1 each, fully paid		200,000	Investments in Subsidiary Company—		
100,000 Ord. Shares of £1 each, fully paid		100,000	Shares as valued by the Directors on 31st December, 1930	70,000	
		300,000	Shares acquired during year to 31st December, at Cost	30,000	
Loan at 4% (secured)	£60,000			100,000	
Interest accrued thereon	600	60,600	Second Debenture, at Cost	50,000	150,000
Reserve for Depreciation of Leasehold Properties		17,750	Sinking Fund Policies at Surrender value		17,750
Amount due to Subsidiary Company		2,050	Stock-in-Trade		25,000
Trade Creditors		52,500	Loans to Directors— Amount advanced during year	2,000	
Income-tax Reserve		6,000	*Less* Repaid during year	2,000	—
General Reserve		40,000	Loan to Secretary		500
Profit and Loss Account		25,200	Trade Debtors	70,000	
			Less Reserve for Doubtful Debts	1,400	68,600
			Rates paid in Advance		1,000
			Balance at Bankers		45,000
	£	504,100		£	504,100

Notes. (1) Included in the Sinking Fund Policies is a policy for £20,000, held subject to the rights of the holders of the First Debentures of the Subsidiary Company.

(2) A Debenture for £50,000 given as collateral security for a bank loan which has now been repaid is still held by the bank.

.... } *Directors.*
....

To the Members of Providers, Ltd.

We have examined the above Balance Sheet and have obtained all the information and explanations we have required. In our opinion the above Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state

of the company's affairs according to the best of our information and the explanations given to us and as shown by the books of the company.

....*Auditors,*
Chartered Accountants.

Report of the Directors pursuant to Section 126, *Companies Act,* 1929

The profits of the Subsidiary Company have been taken into account in the above accounts to the extent of the dividend received. The Auditors' Report on the Balance Sheet of the Subsidiary Company as at 31st July is qualified in the following terms: "No provision has been made for depreciation of Leasehold Properties."

....} *Directors.*
. . . .

Notes to Solution. (1) It has been assumed that the Ordinary Dividend has been paid free of tax.

(2) It has been assumed that the Sinking Fund policy for £20,000 taken out by A Ltd. and assigned to Providers Ltd., subject to rights of the First Debenture-holders of A Ltd., is included in the Sinking Fund Policies shown in the Trial Balance, since the premium does not appear to have been debited to Profit and Loss Account.

(4) *The Central Electric Power Supply Co. has an Authorized Capital of £2,000,000. On 1st January there had been issued 300,000 6 per cent Cumulative Preference Shares of £1 each and 400,000 Ordinary Shares of £1 each, both classes being fully paid.*

The Loan Capital authorized is one-half of the issued Share Capital, provided one-half thereof is paid up. At 1st January, 5 per cent Mortgages amounting to £50,000 had been issued of which £7,000 had been purchased and cancelled. Also, at that date there was outstanding 5½ per cent Debenture Stock amounting to £220,000.

During the year ended 31st December, the following operations took place—

The company acquired at par 3,600 Ordinary

Shares of £1 each, fully paid, of The Counties Power and Light Co. Ltd., by the exchange of Ordinary Shares on the basis of 22s. 6d. per share.

An offer to the Ordinary Shareholders of one new Ordinary Share, at £2 per share, for every four held, resulted in the issue of 85,000 shares.

The company gave notice of the intention to redeem the Debenture Stock on 1st January following the date of the Balance Sheet. The holders were given the option to convert their holdings into a like amount of new 4 per cent Debenture Stock. £250,000 of new stock was created of which £190,000 was accepted in exchange by holders of the old stock and the balance was sold at £102 per cent and the cash received.

In addition to the foregoing, the following balances appeared in the books of the company on 31st December—

	£	£
Land, Buildings, Machinery, Mains, etc., 1st January	1,050,000	
Land, Buildings, Machinery, Mains, etc., expended during the year	75,000	
Sundry Debtors	96,000	
Accrued Interest on Mortgages and Debenture Stocks		6,550
Investments at cost (Market Value £32,670)	30,450	
Contingency Account		25,000
Revenue Account		164,890
Subsidiary Companies—		
Investments	33,600	
Loan	2,800	
Current Accounts	3,600	11,850
Stores, Materials and Work-in-Progress	58,540	
Interest on Mortgages, Debenture Stocks and Loans	15,430	
Payments in advance	820	
Cost of Special Acts and Orders	18,750	
Reserve Fund for 5% Mortgages		10,000
Preliminary Expenses and Costs of Issue of Shares and Debentures	45,000	
Redemption Fund for 5½% Debentures		23,200
Sundry Creditors, Accrued Liabilities and Income-tax		89,150
Interim Dividends paid	19,000	
Depreciation and Reserve Account		54,320
Balance at Bankers	145,380	
Cash in hand	250	
Interest and Dividends		4,860
Service Contributions to Depreciation Fund		10,600

During the year plant to the value of £9,360 had been scrapped, of which £2,160 was to be charged to Revenue Account and the balance to the Depreciation and Reserve Account. The Preliminary Expenses were also to be written off against this account.

The directors decided to credit the premiums received on the issue of shares and debentures to the Depreciation and Reserve Account and to make the following allocations from Net Revenue—

	£
To Reserve Fund for 5% Mortgages	500
,, *Redemption Fund for 5½% Debenture Stock*	5,500
,, *Depreciation and Reserve Account*	50,000
,, *Contingency Account*	5,000

You are required to prepare the Net Revenue Account for the year and the Balance Sheet as on 31st December.

Note. The company has not adopted the Double Account system.

NET REVENUE ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER

	£		£
To Interest on Mortgages, Debenture Stocks and Loans	15,430	By Revenue Account	164,890
„ Interim Dividends	19,000	„ Interest and Dividends	4,860
„ Plant Scrapped	2,160		
„ Reserve Fund, 5% Mortgages	500		
„ Redemption Fund 5½% Debenture Stock	5,500		
„ Depreciation and Reserve Account	50,000		
„ Contingency Account	5,000		
„ Balance carried forward	72,160		
£	169,750	£	169,750

Note. The Depreciation and Reserve Account is made up as follows—

	£		£
To Plant Scrapped	7,200	By Balance brought foward	54,320
„ Preliminary Expenses	45,000	„ Service Contribution	10,600
„ Balance carried forward	149,320	„ Net Revenue	50,000
		„ Share Premium	85,000
		„ „ ⅑ of £3,600	400
		„ Debenture Premium	1,200
£	201,520	£	201,520

CENTRAL ELECTRIC POWER SUPPLY CO. LTD.

BALANCE SHEET AS AT 31ST DECEMBER

Capital and Liabilities		£	*Assets*		£
Capital—			Land, Buildings, Machinery, Mains, etc., at Cost		1,115,640
Authorized		2,000,000	Cost of Special Acts and Orders		18,750
Issued:			Subsidiary Companies—		
300,000 6% Cum. Pref. Shares of £1 each, fully paid	£300,000		Investments, Cost	£33,600	
488,200 Ord. Shares of £1 each, fully paid	488,200		Loan	2,800	
		788,200	Current Accounts	3,600	
5% Mortgages		43,000			40,000
5½% Debenture Stock (Redeemable 1st January next)		220,000	Investments, at Cost (Market value £36,270.)		34,050
(*Note.* Holders of £190,000 Stock have agreed to accept 4% Stock in Exchange on 1st January.)			Stores, Materials, and Work-in-Progress		58,540
4% Debenture Stock		60,000	Sundry Debtors		96,000
Accrued Interest on Mortgages and Debenture Stocks		6,550	Payments in Advance		820
Contingency Account		30,000	Balance at Bankers		145,380
Subsidiary Company Current Account		11,850	Cash in Hand		250
Reserve Fund for 5% Mortgages		10,500			
Redemption Fund for 5½% Debentures		28,700			
Sundry Creditors, accrued Liabilities and Income-tax		89,150			
Depreciation and Reserve Account		149,320			
Net Revenue Account		72,160			
		£1,509,430			£1,509,430

Notes. (1) It has been assumed that the 5 per cent Mortgages are not Debentures.

(2) It has been assumed that the market value of the 3,600 shares in the Counties Power & Light Co. Ltd., is their par value.

(3) It has been assumed that the cost of Special Acts and Orders is not intended to be written off with the Preliminary Expenses.

(5) *The Directors of Blank Co. Ltd. ask you to prepare the Balance Sheet as on 31st December, and Profit and Loss Account for the year ended on that date, in a form suitable for presentation to the members at the Annual General Meeting.*

The balances on the books after closing the Trading Account are as follows.

	£		£
Debits			
Subsidiary Co., Current A/c	6,500	*Trade Debtors*	90,000
Investments in Subsidiary Co. at cost—		*Balance at Bankers*	62,150
Shares £50,000, Debentures £20,000	70,000	*Freehold Properties, at cost*	500,000
Other Investments at cost—		*Plant and Machinery, at cost* less *depreciation*	200,000
Extras Ltd., 10,000 Ord. Shares of £1 each, 15s. paid	5,000	*Credits*	
Imports Ltd., 5,000 Ord. Shares of £1 each, fully paid	5,000	*Shares issued—*	
Stock (as valued by the Directors)	65,500	*Preference (300,000)*	300,000
Final Dividends for the previous year (Gross)	29,000	*Ordinary (300,000)*	300,000
Preference Dividend paid for ½ year to 30th June (Net)	6,975	*Profit and Loss A/c*	45,000
Debenture Interest paid for ½ year to 30th June (Net)	3,875	*Reserve for Depreciation of Freehold Properties*	70,000
Income-tax Account	12,500	*5% Debentures, secured by a floating charge on all the assets*	200,000
		Trade Creditors	40,500
		Trading Account Balance	100,000
		Interest on Investments	1,000

The Authorized Capital of £800,000 (400,000 6 per cent Cumulative Preference and 400,000 Ordinary Shares) was increased during the year by the creation of 25,000 Deferred Shares of £1 each, following an agreement between the company and Exploiters Ltd., whereby the latter waived certain prospective rights against the company. The agreement was dated 16th December and the shares were allotted, credited as fully paid up, on that date.

£14,000 is to be provided as a reserve for income-tax, which is to be taken as 4s. 6d. in the £.

The Managing Director is entitled by his agreement to a commission of 3 per cent of the net profits for the year before providing for such commission or Directors' fees and before crediting interest on investments.

The Directors' fees are fixed under the Articles at 5 per cent of the net profit for the year after providing for the year's dividend on the Preference Shares, in addition to all expenses (including such fees), but before crediting interest on investments.

Your examination of the audited accounts of the subsidiary company reveals—

(1) That the year's trading resulted in a profit of £8,000.

(2) *That the sum of £2,500 was paid to the Directors, including £250 Managing Director's salary.*

(3) *That the Auditors' report to the members is qualified by the words "subject to the value of the investments."*

BLANK CO. LTD.

BALANCE SHEET AS AT 31ST DECEMBER

Capital and Liabilities	£	£	*Assets*	£	£
Share Capital—			Freehold Properties, at cost	500,000	
Authorized:			*Less* Reserve for Depreciation	70,000	
400,000 6% Cum. Pref. Shares of £1 each	400,000				430,000
400,000 Ord. Shares of £1 each	400,000		Plant and Machinery at cost, *less* depreciation		200,000
25,000 Deferred Shares £1 each	25,000		Investments, at cost		10,000
	£825,000		Investments in Subsidiary Co. at cost—		
Issued:			Shares	50,000	
300,000 6% Cum. Pref. Shares of £1 each, fully paid	300,000		Debentures	20,000	70,000
300,000 Ord. Shares of £1 each, fully paid	300,000		Balance due from Subsidiary Co.		6,500
25,000 Deferred Shares of £1 each, fully paid	25,000	625,000	Stock (as valued by the Directors)		65,500
5% Debentures (secured by floating charge)	200,000		Trade Debtors		90,000
Interest accrued thereon	5,000	205,000	Balance at Bankers		62,150
Creditors—			*Note.* There is a contingent liability in respect of uncalled capital on Investments amounting to £2500.		
Trade	40,500				
Expenses	6,000				
Reserve for Income Tax	14,000	60,500			
Profit and Loss Account		43,650			
	£	934,150		£	934,150

STATEMENT ANNEXED TO BALANCE SHEET, UNDER § 126, COMPANIES ACT, 1929:

No credit has been taken in the above accounts for the profits made by the Subsidiary Company. The Auditors' report to the Members of the Subsidiary Company is qualified by the words: "Subject to the value of the investments."

.... } *Directors.*
....

PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER

		£		£
To Debenture Interest		10,000	By Balance from Trading Account, *less* Managing Director's Commission	97,300
„ Directors' Fees	£5,550		„ Interest on Investments	1,000
Less Paid by Subsidiary Company	2,250			
		3,300		
„ Balance, Net Profit carried down		85,000		
		£98,300		£98,300
To Income-tax		23,350	By Balance brought forward	45,000
„ Preference Dividend for ½ year to 30th June		9,000	*Less* Final Dividends for last year	29,000
„ Rights against the Company discharged by the issue of 25,000 Deferred Shares, now written off		25,000		16,000
„ Balance carried forward		43,650	„ Net Profit for year	85,000
	£	101,000	£	101,000

Note. It is not legally necessary to disclose the Managing Director's commission in the published accounts, and this has therefore been deducted from the balance brought down from the Trading Account.

(6) *The following are the revenue balances remaining in the books of Blank Co. Ltd., as on 31st December, 19..: Trading Account (Gross Profit for year to date), £90,000; Salaries, £7,500; Rent and Rates, £6,000; Repairs and Maintenance, £15,000; Sundry Expenses, £10,000; Bank Charges, £1,000; Debenture Interest, £2,500; Income-tax (Schedule D), £5,000.*

The Directors are entitled to remuneration for the year of £4,000 free of tax, and provision must be made for this charge. (Income Tax at 4s. in £.)

The Managing Director is entitled, under his agreement with the company, to 5 per cent of the profits for the year (after providing for such percentage), but a condition of the agreement is that, for the purpose of calculating his commission, the charge for Repairs and Maintenance shall not exceed 30 per cent of the total of the debits mentioned above,

excluding those for Repairs and Maintenance and for Managing Director's percentage.

Prepare the Profit and Loss Account for the year ended 31st December, and show your calculation of the Managing Director's remuneration.

PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER

	£	s.	d.		£	s.	d.
To Salaries	7,500	0	0	By Gross Profit b/f.	90,000	0	0
,, Rent and Rates	6,000	0	0				
,, Repairs and Maintenance	15,000	0	0				
,, Sundry Expenses	10,000	0	0				
,, Bank Charges	1,000	0	0				
,, Debenture Interest	2,500	0	0				
,, Income-tax (Schedule D)	5,000	0	0				
,, Directors' Fees	4,000	0	0				
,, Income Tax thereon	1,000	0	0				
	52,000	0	0				
,, Managing Director's Commission	1,995	4	9				
,, Net Profit	36,004	15	3				
£	90,000	0	0	£	90,000	0	0

Notes. (1) It is assumed that the agreement between the company and the Directors provides that "free of tax" means that the company will pay income-tax on the gross sum which, after deduction of the tax thereon, will leave the net fees of £4,000. This is not the most common form of agreement but, in the absence of other information, is the only relevant assumption.

(2) In the absence of agreement to the contrary, income-tax is not a proper deduction before calculating a Managing Director's Remuneration (*Johnston* v. *Chestergate Hat Manufacturing Co.*). In view, however, of the terms of the agreement regarding the computation of the charge for Repairs and Maintenance, it has been assumed that the agreement provides for the charge in this case. Income-tax on Directors' Fees is simply an addition to the Fees, and is therefore a proper charge.

Calculation of Managing Director's Commission—

	£	£
Gross Profit		90,000
Expenses	52,000	
Deduct Repairs and Maintenance	15,000	
	37,000	
Add do. 30% of £37,000	11,100	
		48,100
Net Profit on which Commission is Payable		£41,900

Commission @ $\frac{5}{105} \times £41,900 = £1,995\ 4\ 9$

(7) *The Northgood Clothing Co. Ltd. (the Directors of which are A. Board and C. Done) makes up its accounts annually to 31st July. At the stock-taking date the following balances appeared in the books—*

	£
Land and Buildings	3,960
Issued Capital—Shares of £1 each, fully paid	17,500
Plant and Machinery	4,210
Opening Stock and Work-in-Progress	5,956
Discounts received	490
General Repairs	324
Office Expenses	214
Machinists' Wages	13,851
4,000 *Shares in XY Ltd., at cost*	4,050
Agents' Commissions and Expenses	1,296
Rates and Insurances	149
Workroom Expenses	136
Travelling Expenses	335
Sales, less Returns	53,494
Boxes and Packing materials	963
Fixtures and Fittings	620
Materials purchased	24,865
Purchase returns	280
Balance at Bank and Cash in hand	1,682
Loan to XY Ltd. (without interest)	2,000
Bank interest, Commission and Charges	40
Discounts allowed	1,493
Gas, Water and Electricity	348
Bad Debts written off	64
Profit and Loss Account—Credit balance brought forward	4,975
Gross Dividends paid for previous year	1,750
Managing Directors' Salaries	1,000
Directors' Fees	100
Income-tax Account—Debit Balance	435
Staff Wages	2,158
Office Salaries	520
Sundry Debtors (including £1,500 loaned to A. Board on 30th July)	6,740
Sundry Creditors (including a liability for finishing charges of £150 carrying a lien for work done)	2,520

On inquiry the following further information is obtained—

(1) *The unissued share capital consists of 2,500 shares.*

(2) *The following additions to fixed assets have been made during the year—*

Plant and Machinery £350. Fixtures £80.

(3) *Stock-in-Trade and Work-in-Progress on* 31st *July was valued by the Directors at* £6,120.

(4) *The following items were estimated to be outstanding at the close of the year—*

Machinists' wages £178. *Agents' Commissions* £64. *Rates and Insurance paid in advance* £38, *and Income-tax, Schedules A and D,* £275.

(5) *Depreciation is to be provided on the written-down values at the commencement of the year at the following rates—*

Land and Buildings	2½ *per cent*
Fixtures and Fittings	5 ,,
Plant and Machinery	15 ,,

(6) *The issued capital of XY Ltd. consists of* 6,000 *shares of* £1 *each fully paid.*

The holding in this company was acquired on the incorporation of XY Ltd. on 18*th April. No accounts have yet been prepared by XY Ltd., but C. Done has received* £50 *on account of his fee as a Director of that company.*

(7) *A Bad Debt Reserve of* £120 *is to be created and Discount reserves of* 2½ *per cent are to be provided in respect of the good trade debts and sundry creditors respectively.*

You are required to prepare—

(*a*) *Trading and Profit and Loss Accounts for the year, and*

(*b*) *A Balance Sheet at the close, drawn up to comply with the requirements of the Companies Act,* 1929.

TRADING AND PROFIT AND LOSS ACCOUNTS
FOR THE YEAR ENDED 31ST JULY

	£	s.	d.		£	s.	d.
To Stock and Work-in-Progress 1st August	5,956	0	0	By Sales, less Returns	53,494	0	0
" Purchases, less Returns	24,585	0	0	" Stock-in-Trade and Work-in-Progress, 31st July	6,120	0	0
" Machinists' Wages	14,029	0	0				
" Workroom Expenses	136	0	0				
" Gross Profit c/d	14,908	0	0				
£	59,614	0	0	£	59,614	0	0
To Salaries	1,520	0	0	By Gross Profit b/d	14,908	0	0
" Staff Wages	2,158	0	0	" Discounts	553	0	0
" Directors' Fees	100	0	0				
" Rates and Insurances	111	0	0				
" Gas, Water, and Electricity	348	0	0				
" General Repairs	324	0	0				
" Office Expenses	214	0	0				
" Agents' Commissions and Expenses	1,360	0	0				
" Travelling Expenses	335	0	0				
" Boxes and Packing Materials	963	0	0				
" Discounts	1,621	0	0				
" Bank Interest, Commission and Charges	40	0	0				
" Bad Debts £64 Do. Reserve 120	184	0	0				
" Depreciation— Land and Buildings £99 Fixtures and Fittings 27 Plant and Machinery 579	705	0	0				
" Net Profit c/d	5,478	0	0				
£	15,461	0	0	£	15,461	0	0
To Dividends for last year	1,750	0	0	By Balance b/f	4,975	0	0
" Income-tax Account	710	0	0	" Net Profit b/d	5,478	0	0
" Balance c/f	7,993	0	0				
£	10,453	0	0	£	10,453	0	0

THE NORTHGOOD CLOTHING CO. LTD.

Balance Sheet, as at 31st July

Capital and Liabilities		£	s.	d.	*Assets*		£	s.	d.
Capital— Authorized: 20,000 Shares of £1		20,000	0	0	Land and Buildings, at cost less depreciation . .		3,861	0	0
Issued 17,500 Shares of £1 fully paid . .		17,500	0	0	Plant and Machinery, at cost less depreciation .		3,631	0	0
Sundry Creditors	£2,520				Fixtures and Fittings, at cost less depreciation . .		593	0	0
Less Discount Reserve	63				Shares in Subsidiary Company, at cost . . .		4,050	0	0
		2,457	0	0	Stock-in-Trade and Work-in-Progress . .		6,120	0	0
Expense Creditors .	242				Loan to Subsidiary Company.		2,000	0	0
Income-tax Reserve .	275				Loan to Director made 30th July, 19. . . .		1,500	0	0
		517	0	0	Trade Debtors	£5,240			
Profit and Loss Account		7,993	0	0	*Less*— Bad Debt Res. £120, Discount Res. 128	248			
A. Board, C. Done, } *Directors*							4,992	0	0
					Payments in Advance . .		38	0	0
					Balance at Bank and Cash in hand		1,682	0	0
£		28,467	0	0	£		28,467	0	0

Auditors' Report to the Members:

We have examined the above Balance Sheet, and have obtained all the information and explanations we have required. In our opinion, the Balance Sheet is properly drawn up so as to disclose a true and correct view of the state of the Company's affairs, according to the best of our information and the explanations given to us and as shown by the books of the Company.

Chartered Accountants,
Auditors.

Statement by the Directors pursuant to Section 126, *Companies Act,* 1929*:*

No accounts have yet been prepared by the Subsidiary Company, which was incorporated on 18th April, 19...

A. Board,
C. Done, } *Directors.*

Notes. (1) Since both the directors are managing directors, it is not necessary to disclose the directors' fees paid to them, although this is usual in the detailed accounts. Neither need mention be made of fees received by a managing director from a subsidiary company.

(2) It is considered that the liability in respect of which a creditor has a lien on goods belonging to the company is a liability which is secured by the operation of law, and, therefore, it is not necessary to disclose in the Balance Sheet the fact that the liability is secured (Companies Act, 1929, S. 124 (3)).

CHAPTER IX

PROFITS

Divisible profits—Dividends—Interest out of capital—Bonuses

Since this work does not purport to deal with legal principles, a discussion of what profits are available for dividend and what are not would be out of place. It is felt, however, that readers will appreciate the following brief summary of the law, although it must be emphasized that the circumstances of each case must be examined on its merits before deciding whether particular profits are available for dividend.

The Memorandum and Articles must be examined carefully, since it may be found that the excess of the proceeds of sale over the cost of particular assets, e.g. investments, are expressly required to be capitalized, even if the company is actually dealing in such assets. Subject to the Memorandum and Articles, the minimum legal requirements as to profits available may be summarized as follows—

(*a*) The excess of current income over current expenditure is available, provided depreciation of floating assets has been provided for and funds have been retained for paying liabilities.

(*b*) Depreciation of fixed assets need not in all cases be provided.

(*c*) Capital profits are available if realized and remaining after making good capital losses, i.e. after a revaluation of all assets and liabilities fairly taken.

(*d*) Capital losses need not necessarily be made good before dividing revenue profits, but capital profits cannot be divided without making good capital losses, nor revenue profits before making good revenue losses.

(*e*) Past losses need not always be made good before dividing current profits.

(*f*) Dividends cannot be paid out of capital, i.e. although capital profits may, as already stated, be divisible in certain circumstances, the assets representing the company's fixed capital cannot be paid to the members, as this would be an unauthorized reduction of capital.

DIVISIBLE PROFITS

It is not recommended that a company should pay dividends "up to the hilt," keeping just within the minimum requirements mentioned. Sound commercial policy necessitates that provision be made for all depreciation, including that on fixed assets; and that current profits be not distributed until past losses have been recouped out of profits. Where a company has sustained a capital loss, it may be desirable to spread this over a series of years, but the facts should be clearly indicated in the Balance Sheet, i.e. an asset which has been lost must not appear in the Balance Sheet as intact.

The Balance Sheet must show a position of affairs which is, at least, not better than that which in fact exists, although there is no legal bar to the Balance Sheet showing a position which is worse than that which in fact exists, e.g. a company may create secret reserves, provided that these are not employed to the detriment of members or creditors.

A secret reserve is a reserve which exists but is not disclosed on the face of the Balance Sheets and may be created in any of the following ways—

(1) By writing off assets, so that valuable assets are omitted entirely from the Balance Sheet. Excessive provision for depreciation creates a secret reserve.

(2) By the inflation of liabilities, e.g. including reserves with creditors.

(3) By grouping tangible and intangible assets, where in fact the intangible assets, although of value, are included at purely nominal figures. The person examining the Balance Sheet would tend to discount the total.

(4) By making specific reserves for contingent liabilities.

(5) By charging capital expenditure to revenue.

(6) By crediting unusual profits direct to Reserve without disclosing them.

Secret reserves must be used with care, as they obscure the position of affairs, including the profits made. If transfers to the credit of Profit and Loss Account are made from such reserves, the fact should be stated. Directors might manipulate such reserves to make personal profits from dealing in the company's shares. On the other hand, secret reserves undoubtedly strengthen the business, and in the case of non-trading concerns such as banks may be most desirable.

Secret Reserves may arise from appreciations in value of assets, as distinct from deliberate creation; such reserves should not be drawn upon except in exceptional circumstances.

DIVIDENDS

The declaration of dividends is usually in the hands of the members in general meeting, although the Articles often empower directors to declare interim dividends. Before declaring interim dividends, the directors must satisfy themselves that profits are available by the preparation of interim accounts.

Illustration. *A company had a credit balance of* £21,700 *on Profit and Loss Account. Its issued share capital consisted of—*

60,000 £1 6 *per cent Preference Shares, fully paid;* 100,000 £1 *Ordinary Shares,* 15*s. paid.*

At the Annual General Meeting held on 28*th March,* 1936, *it was resolved that the final dividend for the half-year ended* 28*th February,* 1936, *on the preference shares be paid forthwith, and that a dividend of* 10 *per cent be paid on the ordinary shares. Show the Ledger Accounts affected.*

PROFIT AND LOSS ACCOUNT

1936		£	s.	d.	1936		£	s.	d.
Mar. 28	To Preference Share Dividend Account, ½ year to 28th Feb. 1936 .	1,800	0	0	Mar. 1	By Balance b/f .	21,700	0	0
	„ Ordinary Share Dividend Account, year to 28th Feb. 1936 .	7,500	0	0					
	„ Balance c/f . .	12,400	0	0					
	£	21,700	0	0		£	21,700	0	0

PREFERENCE SHARE DIVIDEND ACCOUNT

1936		£	s.	d.	1936		£	s.	d.
Mar. 28	To Income Tax Account, 4s. 6d. in £ . . .	405	0	0	Mar. 28	By Profit and Loss Account . .	1,800	0	0
	„ Cash . . .	1,395	0	0					
		£1,800	0	0			£1,800	0	0

ORDINARY SHARE DIVIDEND ACCOUNT

		£	s.	d.			£	s.	d.
1936 Mar. 28	To Income Tax Account, 4s. 6d. in £ . . .	1,687	10	0	1936 Mar. 28	By Profit and Loss Account . .	7,500	0	0
	" Cash . . .	5,812	10	0					
		£7,500	0	0			£7,500	0	0

As soon as a dividend is declared, it is advisable to open up a special Dividend Account, designated by a distinctive number, at the company's bankers, transferring thereto from general funds the amount of cash required to pay the dividend. The amount of unclaimed dividends is then at once apparent, and the checking of the paid warrants is greatly facilitated, apart from the convenience of having the general funds relieved of such details.

The method of treating details is then a matter of personal preference. Some accountants prefer to debit the Dividend Account and credit Dividend Cash Account at once with the full amount of the warrants sent out, as shown in the above example. If any dividends are unclaimed, an amount equal thereto is written back by debiting Cash and crediting Dividend Account.

Others prefer to leave the entries over until the warrants have been paid by the bank, and then to debit Dividend Account and credit Dividend Cash Account with the warrants actually paid. The ultimate result is obviously the same, viz. the balance on Dividend Account represents unclaimed dividends to be shown as a liability on the Balance Sheet.

After a certain interval, e.g. three years, it is common to transfer the unclaimed dividends to an "unclaimed dividends account," and either to

retransfer the cash in respect thereof to general fund or to invest such cash.

Articles commonly follow Table A, which provides that, subject to the rights of persons, if any, entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts paid on the shares, but if and so long as nothing is paid up on any shares, dividends may be declared and paid according to the amounts of the shares. No amount paid on a share in advance of calls shall, while carrying interest, be treated for this purpose as paid on the share. Before recommending any dividend, the directors may set aside reserves for contingencies or for the equalization of dividends or other purposes for which the profits may properly be applied. No dividend shall bear interest against the company.

If a call is not paid by the date appointed for payment, interest is chargeable at 5 per cent per annum from the due date, but the directors may waive payment of that interest wholly or in part.

The directors may receive from any member willing to advance the same all or any part of the moneys uncalled and unpaid upon his shares, and upon all or any of the moneys so advanced may (until the same would but for such advance become presently payable) pay interest at such rate (not exceeding, without the sanction of the company in general meeting, 6 per cent) as may be agreed upon between the member paying the sum in advance and the directors.

Special articles commonly vary the rates mentioned in the above provisions of Table A, e.g. they sometimes provide for interest at 10 per cent.

Table A also gives the company a lien on dividends on partly-paid shares. This enables the company to set off dividends against calls in arrear.

INCOME-TAX IN RELATION TO DIVIDENDS

Income-tax is deductible from all dividends at the standard rate in force for the year in which the dividend is payable, unless the dividend is declared "free of tax." In any case, every dividend warrant must be accompanied by a statement showing the gross amount of the dividend, the tax deducted, and the net amount paid, so that no labour is saved by "free of tax" declaration. Reserve must be made for the full liability to tax before declaring a "free of tax" dividend, whereas, when tax is deducted from dividends, there need only be charged against Profit and Loss Appropriation Account the net tax after recoupment from dividends. The rule: "Charge to Profit and Loss Account the tax borne by the company in the accounting year" is a safe one to employ. If dividends are declared "free of tax," the company bears the whole of the tax (less, of course, any deducted from annual payments). The special rules applicable to those cases where adjustments have to be made for changes in the rate of tax or passing on Dominion Income-tax Relief, must be studied in a treatise on income-tax.

Preference dividends must not be paid "free of tax" unless the terms of issue and the Articles allow, as this would amount to an unauthorized increase in the effective rate of dividend, to the detriment of the other shareholders.

The arguments in favour of showing the payment of a dividend *gross* in the Appropriation Account are as follows—

(1) The *gross* dividend is the *actual* dividend. The deduction of tax from dividends is merely an application of the principle of taxation at source, and the gross amount debited to Appropriation Account coincides with the rate of dividend declared.

(2) Income-tax is an appropriation of profits, not a charge against them. The fund divisible is, therefore, the amount of the profits before charging income-tax. The tax on the profits distributed as dividend is deducted from such profits after they have been appropriated to the members, and the gross amount of such dividends should therefore be disclosed in the accounts.

(3) By debiting the gross dividends to Appropriation Account, comparisons can be made between one year and another on a constant basis, without regard to changes in the rate of tax.

(4) The amount of income-tax actually *borne* by the company, as distinguished from the amount *paid*, is clearly shown.

The arguments in favour of showing the dividends after deduction of tax are—

(1) The income-tax paid is computed on the whole of the adjusted profits, whether distributed or not, and a company may, or may not, recoup tax on the dividends paid. Since the income-tax payable is an actual liability of the company it should be reserved for in full, and the actual amount of such liability should be disclosed in the accounts.

(2) After debiting to Appropriation Account the full amount of tax applicable to the accounting period, the balance represents the net amount available for the payment of dividends, and the net dividends paid are an appropriation from such net amount.

Under each method the income-tax actually payable by the company is debited to Income-tax Account. Where the gross dividends are shown in the Appropriation Account the tax deducted from dividends is debited to Dividend Accounts and credited to Income-tax Account, the net balance of which is then transferred to Appropriation Account. Where, however, the dividends are debited net to Appropriation Account, the transfer from Dividend Accounts to Income-tax Account is not made, but the full amount debited to Income-tax Account is transferred to Appropriation Account.

Where share warrants have been issued, arrangements for paying dividends are usually made by means of coupons attached to the warrants. When a dividend is declared, due advertisement of the fact is made, giving instructions for the deposit of coupons with bankers or with the company. When the supply of coupons is exhausted a "talon" (attached after the last coupon on the warrant) can be detached from the warrant and dispatched to the company as a request for a further sheet of coupons, which in turn will have a "talon" attached to it.

If dividends are paid on the same dates in each year, the coupons may have to be deposited on such dates (per instructions on the share warrant), so obviating advertisement.

In good years, prudent companies commonly set aside a proportion of their profits to a "Dividend Equalization Reserve" on which to draw for the maintenance of dividends in poor years. In order to ensure that the cash required to pay dividends is available, this reserve is preferably invested.

Dividends can only be declared out of profits, but interest on loans, debentures, etc., must be paid even where there are no profits, and can thus be paid out of capital. No interest can be paid on shares (*except* on moneys paid in advance of calls), however, except out of profits, save only in the circumscribed circumstances set out in Section 54 of the Companies Act, 1929, viz.—

Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions mentioned below, and may charge the sum so paid by way of interest to capital as part of the cost of construction of the work or building or the provision of plant.

The conditions are as follows—

(*a*) No such payment shall be made unless it is authorized by the Articles or by special resolution.

(*b*) No such payment, whether authorized by the Articles or by special resolution, shall be made without the previous sanction of the Board of Trade.

(*c*) Before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the inquiry.

(*d*) The payment shall be made only for such period as may be determined by the Board of Trade, and that period shall in no case extend beyond the close of the half year

next after the half year during which the works or buildings have been actually completed or the plant provided.

(*e*) The rate of interest shall in no case exceed four per cent per annum or such other rate as may for the time being be prescribed by Order in Council. (By the Companies (Interest out of Capital) Order, 1929, the maximum rate is, at present, six per cent.)

(*f*) The payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid.

(*g*) The accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate. If default is made in complying with this proviso the company and every officer of the company who is in default is liable to a fine not exceeding fifty pounds.

(*h*) Nothing in this section affects any company to which the Indian Railways Act, 1894 (which contains similar provisions), as amended by any subsequent enactment, applies.

Illustrations. (1) *On the Balance Sheet of a company having a fully-paid issued capital of £100,000 in shares of £1 each the following balances appeared on 31st March—*

	£	s.	d.
6% *Preference Shares Account*	40,000	0	0
Ordinary Shares Account	60,000	0	0
5% *Debenture Stock*	40,000	0	0
General Reserve Account	25,000	0	0
Profit and Loss Appropriation Account (*Credit*)	34,400	0	0

The annual general meeting was held on 10th May, when it was resolved to pay the year's preference dividend, less tax; to pay 10 per cent on the Ordinary Shares, "free of tax"; to transfer £10,000 to General Reserve Account and to carry forward the balance. Dividend warrants were posted on 12th May.

On 30th June and 31st December the debenture interest was paid and, on 10th January following,

Schedule D tax was paid under Case I, £4,000; Case III £100.

Write up the accounts affected by these transactions, taking income-tax at 5s. in the £.

(No Journal entries are required.)

PROFIT AND LOSS APPROPRIATION ACCOUNT

			£	s.	d.				£	s.	d.
May	10	To Preference Dividend Account	2,400	0	0	Apr.	1	By Balance b/f	34,400	0	0
		„ Ordinary Dividend Account (free of tax)	6,000	0	0						
		„ General Reserve Account	10,000	0	0						
		„ Balance c/d	16,000	0	0						
		£	34,400	0	0			£	34,400	0	0
						May	11	By Balance b/d	16,000	0	0

PREFERENCE DIVIDEND ACCOUNT

			£	s	d.				£	s.	d.
May	10	To Income-tax Account	600	0	0	May	10	By Profit and Loss Account	2,400	0	0
	12	„ Cash	1,800	0	0						

ORDINARY DIVIDEND ACCOUNT

			£	s.	d.				£	s.	d.
May	12	To Cash	6,000	0	0	May	10	By Profit and Loss Account	6,000	0	0

DEBENTURE INTEREST ACCOUNT

			£	s.	d.				£	s.	d.
June	30	To Cash	750	0	0	Dec.	31	By Profit and Loss Account	2,000	0	0
Dec.	31	„ „	750	0	0						
		„ Income-tax Account	500	0	0						
			£2,000	0	0				£2,000	0	0

GENERAL RESERVE ACCOUNT

			£	s.	d.				£	s.	d.
May	10	To Balance c/f	35,000	0	0	Apr.	1	By Balance b/f	25,000	0	0
						May	10	„ Profit and Loss Account	10,000	0	0
			35,000	0	0			£	35,000	0	0

INCOME-TAX ACCOUNT

		£	s.	d.			£	s.	d.
Jan. 10	To Cash, Schedule D, Case I	4,000	0	0	May 10	By Preference Dividend Account	600	0	0
	" Cash, Schedule D, Case III	100	0	0	Dec. 31	" Debenture Interest Account	500	0	0
						" Profit and Loss Account	3,000	0	0
		£4,100	0	0			£4,100	0	0

Note. If a separate Dividend Cash Account had been opened, the cash for payment of dividends would have been transferred thereto from cash, and the posting therefrom to Dividends Accounts would have been made as the warrants were cleared. It has been assumed, however, that no such account was opened.

(2) *The Chips Co. Ltd. had a balance of £61,548 to the credit of Profit and Loss Account. On the recommendation of the directors it was resolved at the Annual Meeting—*

(1) *To pay the half-year's dividend due on £450,000 6 per cent Preference Shares.*

(2) *To pay a dividend of 6 per cent on the £300,000 Ordinary Shares.*

(3) *To pay a dividend of 25 per cent free of tax on £35,000 Deferred Shares.*

(4). *To transfer £1,000 to a Forged Transfers Reserve Account.*

(5) *To give £2,000 to the Staff Benevolent Fund.*

(6) *To take from General Reserve Account the sum of £15,000 for the purpose of writing the Goodwill down to £25,000, leaving on General Reserve £40,000.*

(7) *To carry forward the balance to the next year.*

Give effect to these resolutions in the books of the company, reckoning income-tax at 4s. 6d. in the £.

PROFIT AND LOSS APPROPRIATION ACCOUNT

	£	s.	d.		£	s.	d.
To Preference Share Dividend Account, half-year's dividend at 6% on £450,000	13,500	0	0	By Balance b/f	61,548	0	0
„ Ordinary Share Dividend Account, 6% on £300,000	18,000	0	0				
„ Deferred Share Dividend Account, 25% free of tax on £35,000	8,750	0	0				
„ Forged Transfers Reserve Account	1,000	0	0				
„ Staff Benevolent Fund	2,000	0	0				
„ Balance, c/f	18,298	0	0				
£	61,548	0	0	£	61,548	0	0

GENERAL RESERVE ACCOUNT

	£	s.	d.		£	s.	d
To Goodwill Account—Amount written off	15,000	0	0	By Balance, b/f	55,000	0	0
„ Balance, c/f	40,000	0	0				
£	55,000	0	0	£	55,000	0	0

PREFERENCE SHARE DIVIDEND ACCOUNT

	£	s.	d.		£	s	d.
To Income-tax Account	3,037	10	0	By Profit and Loss Account, half-year's dividend at 6% on £450,000	13,500	0	0
„ Cash	10,462	10	0				

ORDINARY SHARE DIVIDEND ACCOUNT

	£	s.	d		£	s.	d.
To Income-tax Account	4,050	0	0	By Profit and Loss Account, 6% on £300,000	18,000	0	0
„ Cash	13,950	0	0				

DEFERRED SHARE DIVIDEND ACCOUNT

	£	s.	d.		£	s.	d.
To Cash	8,750	0	0	By Profit and Loss Account, 25% free of tax on £35,000	8,750	0	0

FORGED TRANSFERS RESERVE ACCOUNT

					£	s.	d.
				By Profit and Loss Account	1,000	0	0

STAFF BENEVOLENT FUND ACCOUNT

	£	s.	d.		£	s.	d.
				By Profit and Loss Account .	2,000	0	0

GOODWILL ACCOUNT

	£	s.	d.		£	s.	d.
To Balance, b/f	40,000	0	0	By General Reserve—Amount written off . . .	15,000	0	0
				„ Balance, c/f . . .	25,000	0	0

(3) *A private company (capital £60,000 issued) was incorporated on 1st April, to take over a business as from 1st January. The turnover for the year to 31st December was £125,000, of which £25,000 was for the first three months of the year.*

The Gross Profit for the year was £40,000 and the expenses £26,000, including Directors' Fees £2,000.

It was decided to place £3,000 to Reserve and to pay out the balance of available profits to Shareholders.

What dividend was received by them on their shares for the year? Show your calculations.

	Profits Prior to Incorporation		*Profits Subsequent to Incorporation*	
	£	£	£	£
Gross profit apportioned on basis of turnover		8,000		32,000
Expenses	26,000			
Less Directors' Fees	2,000			
	£24,000			
Apportioned on a time basis . . .		6,000	18,000	
Add Directors' fees			2,000	20,000
Carried to capital reserve. . . .		£2,000		
Net profit subsequent to incorporation.				12,000
Less Transfer to reserve . . .				3,000
Profit available for dividend .				£9,000

$$\text{Dividend} = £\frac{9{,}000 \times 100}{60{,}000} = 15\%$$

(4) *The directors of a limited company possessing secret reserves, estimated to amount to £80,000, decide to adjust the Balance Sheet so as to disclose the true position. The £80,000 is made up as follows—*

	£
Deduction of 10% from the value of the Stock	8,500
Profit on the sale of investments operating to reduce the value of the remaining investments below cost and market value	10,000
Over-reserve for income-tax	5,000
Under-valuation of machinery, resulting from excessive provision for depreciation	55,000
Motor Vans written off	1,500

That portion of the £80,000 representing the extent to which revenue has been penalized in the past is to be placed to a Reserve for the equalization of dividends. The remainder is to be placed to a Pension Fund, an equivalent amount to be specifically invested in a gilt-edged security so as to provide for the payment of pensions.

Give Journal entries to record these operations.

JOURNAL

		£	£
	Stock . . . . . *Dr.* To Dividend Equalization Reserve Account Increase of stock to the correct value.	8,500	8,500
	Investments . . . . *Dr.* To Pension Fund Increase of investments to true value by writing back profit on sales. (See Note.)	10,000	10,000
	Income-tax Reserve . . . *Dr.* To Dividend Equalization Reserve Account Transfer of excess reserve.	5,000	5,000
	Machinery . . . . . *Dr.* To Dividend Equalization Reserve Account Excess depreciation written back.	55,000	55,000

JOURNAL—(*contd.*)

		£	£
	Motor Vans . . . . . *Dr.* To Dividend Equalization Reserve Account . . . . Excess depreciation written back.	1,500	1,500
	Pension Fund Investments Account *Dr.* To Cash . . . . . . Investment of sum equivalent to Pensions Fund.	10,000	10,000

Note. It is assumed that the investments are fixed assets and that, therefore, the profit therefrom would not be credited to revenue.

BONUS SHARES

When a company has accumulated a large balance of undistributed profits which it cannot see its way to pay away in dividends, e.g. where profits have been used to acquire fixed assets or are required for working capital, it may decide to capitalize those profits and use them for the declaration of a capital bonus or for paying up calls made at the same time on partly-paid shares. This has the advantage of bringing the issued capital more closely in line with the amount represented by fixed assets and working capital, whilst giving to the members shares which they can realize if they so desire.

The bonus must be sanctioned by the Articles and by a resolution in general meeting, and particulars must be filed with the return of allotments where shares are issued in satisfaction. If the bonus has the effect of increasing the issued capital beyond the authorized capital, the latter must first be increased.

The book entries are simple, viz. debit Profit and

Loss Account (or Reserve if this is being used), credit Bonus Account; and (1) if fully-paid shares are being issued, debit Bonus Account and credit Share Capital Account, or (2) if the bonus is to pay up calls, debit Call Account, credit Share Capital Account, debit Bonus Account, credit Call Account.

If the existing shares stand at a premium on the market, it is usually desirable to issue bonus shares at a comparative premium, in order to disturb the market as little as possible.

Inevitably, the issue of bonus shares in the proportion of one new share for every so many shares held, gives rise to fractional differences, as shareholdings will not all be in exact multiples of the basic number of shares, e.g. an issue of bonus shares in the ratio of one share for every eight shares held will give rise to fractions in all cases where the existing holdings are not in multiples of eight.

To meet this difficulty, fractional rights certificates may be issued, giving the holders the right, on presenting sufficient fractions to make up a whole share, to be issued with a share certificate. The holders can sell their fractions, or buy the necessary fractions, in the market, or the company will make arrangements with one or more members who are willing to buy fractions.

To avoid the work involved in fractions, it is common to declare the bonus to be allotted "to the nearest whole number of shares," or for fractions to be paid out in cash.

Illustrations. (1) *A company had undistributed profits amounting to* £61,000 *and an issued Ordinary Capital of* £400,000 *in* £1 *shares. It was resolved to*

capitalize £50,000 of the profits and issue, in satisfaction of a bonus of that amount, fully-paid shares.

JOURNAL

		£	£
	Profit and Loss Account . . Dr. To Bonus Account . . . Capitalization of profits per resolution of General Meeting of this day.	50,000	50,000
	Bonus Account . . . . Dr. To Ordinary Share Capital Account Issue of one ordinary share of £1 fully paid for every 8 shares held, in satisfaction of bonus.	50,000	50,000

(2) *A company had an issued Share Capital of* 50,000 £1 *Preference Shares and* 80,000 £1 *Ordinary Shares (which stood in the market at* 22*s.* 6*d. each), and undistributed profits amounting to* £21,000, *of which* £10,000 *was in Reserve Account. At an extraordinary general meeting, it was resolved that the Reserve and* £8,000 *from Profit and Loss Account be capitalized and utilized to pay up Ordinary Shares in the ratio of one ordinary share for every five ordinary shares held, at a premium of* 2*s.* 6*d. per share.*

Show the Ledger Accounts involved.

ORDINARY SHARE CAPITAL ACCOUNT

	£		£
To Balance c/f	96,000	By Balance b/f	80,000
		„ Bonus Account . . .	16,000

BONUS ACCOUNT

	£		£
To Ordinary Share Capital Account	16,000	By Reserve Account . . .	10,000
„ Premium Account . . .	2,000	„ Profit and Loss Account .	8,000

PREMIUM ON SHARES ACCOUNT

	£		£
		By Bonus Account . .	2,000

RESERVE ACCOUNT

	£		£
To Bonus Account . . .	10,000	By Balance b/f	10,000

PROFIT AND LOSS ACCOUNT

	£		£
To Bonus Account . .	8,000	By Balance b/f . . .	11,000
„ Balance c/f	3,000		

(3) *A company whose issued capital included 75,000 £1 Ordinary Shares, 15s. called, had undistributed profits amounting to £22,000. It was resolved to declare a bonus of 5s. per share to be applied in making the shares fully-paid.*

Show the Journal entries required to record the bonus.

JOURNAL

		£	£
	Final Call Account . . . . *Dr.* To Ordinary Share Capital Account Final call of 5s. per share on 75,000 Shares, per resolution of this day.	18,750	18,750
	Profit and Loss Account . . *Dr.* To Bonus Account . . . Bonus of 5s. per share on 75,000 Ordinary Shares per resolution of General Meeting of this day.	18,750	18,750
	Bonus Account . . . . . *Dr.* To Final Call Account . . . Satisfaction of call by bonus per above resolution.	18,750	18,750

(4) *During recent years many companies have issued bonus shares. State, as briefly as you can, the*

effect of such an issue (a) from the point of view of the company and (b) from the point of view of the shareholder.

The advantages and disadvantages of the policy of issuing bonus shares are as follow—

(*a*) *From the point of view of the company.*

(1) The profits are retained permanently in the business, and thus provide additional working capital and enable the company to extend its operations.

(2) If the company does not modify its policy with regard to the maintenance of adequate reserves, or substantially increase its profits, the distribution of the profits over a larger number of shares will reduce the *rate* of dividend paid on the shares, and this may be desirable in order to bring the rate into line with that of similar companies.

(3) On the other hand, if the company desires to maintain its former rate of dividend on the increased capital, a larger *amount* of profit will have to be distributed, and this may render it more difficult for the company to maintain adequate reserves. The larger distributions of profit may deplete working capital, and the company may, in consequence, experience difficulty in financing its operations.

(4) Where, however, additional revenue-producing assets are purchased with the profits which are capitalized, the above criticism would not apply, as the position would be the same as if the company had distributed the profits in cash, and had then made a new issue of shares for cash, the proceeds of the new issue being applied in procuring assets

wherewith to enlarge the profit-earning capacity of the company.

(*b*) *From the point of view of the shareholders.*

(1) Although the cash position of the company is not weakened, the shareholders receive the profits in a form in which, if desired, they can be realized in cash by sale on the market.

If, however, the bonus is to be utilized for the purpose of paying up calls on the shares, this will increase their value but will not be capable of separate realization.

(2) The distribution of bonus shares does not attract sur-tax.

(3) Unless the company increases its profits, the *rate* of dividend paid on the shares will be reduced, and this may depress the market price per share (although, of course, the value of the *total* holding, including the bonus shares, should not be reduced).

(4) If, in order to maintain the rate of dividend, the company allows its reserves to become depleted, the security behind the shares will be diminished, and ultimately they may depreciate in value in consequence.

(5) The issue of bonus shares may induce speculative dealing in the company's shares on the market, causing wide fluctuations in the value of the shares.

(6) If the profits are distributed in the form of redeemable preference shares, these may be redeemed in cash by the company, and thus the profits will, in effect, be distributed in cash, but in such a way as to render them immune from sur-tax in the hands of the members. (It should be

noted, however, that under Section 21, Finance Act, 1922, and Section 31, Finance Act, 1927, the Special Commissioners of Inland Revenue may have power to charge sur-tax on the company in certain circumstances.)

The authorized and issued capital of a private limited company consists of 3,000 *ordinary shares of* £1 *each and* 3,000 6 *per cent cumulative preference shares of* £1 *each, both fully-paid. There is a sum of* £12,000 *standing to the credit of Profit and Loss Account representing undistributed profits which have been utilized for the development of the business.*

Describe the procedure to be adopted in order to capitalize the profits, and show by Journal entries the adjustments necessary to give effect to your proposals.

Assuming that the company's original Articles authorize the satisfaction of a dividend or bonus by the issue of fully-paid shares, or have been altered by special resolution to confer such power, the procedure is as follows—

(1) Pass a resolution in general meeting to increase the authorized capital by 12,000 ordinary shares of £1 each. If the Articles do not give the necessary power, they must first be altered by special resolution.

(2) File with the Registrar of Companies within fifteen days notice of the increase and a print of the resolutions passed (if special or extraordinary) and pay the stamp duties and fees.

(3) Pass a resolution in general meeting declaring a bonus to the ordinary shareholders of £12,000 free of tax to be satisfied by the issue of fully-paid ordinary shares in the ratio of four new shares for

each one held at that date. It is sometimes thought expedient to appoint a member to enter into an agreement with the company on behalf of the members to accept the shares as fully-paid in satisfaction of the bonus, but this does not appear to serve any useful purpose, as he cannot bind persons who have not concurred in his appointment.

(4) Pass a resolution of the board of directors allotting the shares, post the allotment letters, sign and seal the share certificates, and issue them.

(5) File a return of allotments, with particulars of the consideration, which must be stamped as if it were a formal contract.

(6) Write up the accounts in the financial books and in the Register of Members.

Note. It appears that the dividends on the Preference Shares have been paid in full, and, therefore, the whole of the undistributed profit is divisible among the Ordinary Shareholders.

CHAPTER X

RECONSTRUCTIONS

THE term "reconstruction" as applied to a company embraces any alteration to the capital structure, including reduction of capital, reorganization of rights of various classes of members, sale to a new company to carry on the existing business, etc.

A company which has been very successful may find that it has accumulated surplus funds in excess of its future requirements, and decide accordingly to return the surplus to its members in reduction of their capital. The procedure is under Sections 55 *et seq.* of the Companies Act, 1929, involving a special resolution and sanction of the Court. The formal procedure does not come within the scope of this work; the book-keeping entries are of the simplest, viz. Dr. Share Capital Account(s), Cr. Cash.

Reconstruction is more common, however, where a company has had a poor period or periods, and finds that some of its assets are considerably over-valued or lost, and that there is an accumulated debit balance on Profit and Loss Account, although it is expected that profits will be made in the future. It is decided to write down the capital, and use the amounts so written off in eliminating the fictitious "assets," e.g. the debit balance on Profit and Loss Account, and reducing the assets to current "going-concern" values. The procedure is under Section 55 *et seq.*

The first step in such a case is to determine the

amount required to provide the necessary fund to write off the fictitious assets, etc., and then to evolve a fair allocation of the loss of capital over the members. In serious cases, it may be possible to bring creditors and/or debenture-holders into the scheme, since a common sacrifice may be to the advantage of all.

All assets should be revalued. Goodwill (if any) should be eliminated as a "lost" asset, and any other intangible assets should be carefully examined. The aim must be to produce a Balance Sheet which will record the true position and will give the company reasonable prospects of a resumption of dividends on the new capital. In this connexion it must be remembered that where assets are over-valued, the Profit and Loss Account is being correspondingly over-burdened by excessive depreciation.

In deciding the allocation of the loss, the following factors must be borne in mind—

Debenture-holders are content with a lower rate of interest as a return on their investment than members require as dividend, since debenture-holders have greater security of capital. The greater the risk, the higher the return expected. If, however, the debenture-holders can be shown that it is a fact that on a liquidation a portion of their capital would be irretreviably lost, they may be persuaded to make some sacrifice in return for the prospects of their security improving again. It would rarely be possible to induce the debenture-holders to participate in a reduction if their capital were not jeopardized, but since debenture-holders normally seek long term investment, they

may consent to join in a scheme provided there is, in addition to the above-mentioned prospects, an immediate compensation in a higher rate of interest. Where necessary, debenture-holders may be given a share in the "equity," part of the consideration for their sacrifice of rights taking the form of ordinary shares which will give them the chance of recouping the amount of their sacrifice when the company prospers.

Creditors (other than those who would be preferential in a winding up) can often be induced to share in a reduction scheme, where it can be shown that there would be little or nothing left for them in the event of winding-up, e.g. owing to the prior claims of debenture-holders. A prospect of a higher dividend on their debts, if they join in the scheme, is often sufficient inducement, e.g. if the estimated return on a winding-up is 5s. in the £, an offer of 7s. 6d. or 10s. in the £ may secure their support. Sometimes, again, ordinary shares may be offered to them in part satisfaction of their reduced debt.

Some sort of moratorium is commonly essential to enable the company to provide the funds required to pay the reduced debts due.

As between the various classes of members, it is often difficult to devise an acceptable scheme. It must be borne in mind that if preference shareholders are preferential as to a return of capital in a winding-up, they will argue that any capital loss must fall first on the ordinary members, as it would in a liquidation. The ordinary members, however, will naturally object to bearing the whole of the loss, where this is considerable, on grounds

such as: (1) that in a winding-up neither class of members would get any return of capital, (2) in prosperous years reserves were created out of profits available for ordinary dividends, and these reserves were subsequently drawn upon to pay preference dividends; accordingly the ordinary members have lost considerable sums already, (3) in return for the prospects of immediate dividends, the preference members should make some capital sacrifice. If the reduction does not take place, of course the debit balance on Profit and Loss Account will absorb all profits made until it is extinguished. It is true that the ordinary shareholders are also obtaining enhanced prospects of early dividends, and they must make a greater sacrifice, otherwise they would benefit at the expense of the preference shareholders, as the whole of the profits available after paying preference dividends belong to the ordinary members, and merely writing down the face value of the ordinary shares would not alter the proportion or amount of such profits attributable to each. To overcome this objection, the ordinary members may yield up some of their shares to the preference members.

If the preference shareholders have a right to share in surplus, then writing down the value of the ordinary shares directly involves a capital sacrifice on the part of the holders of the ordinary shares, but if, as is common, the preference shareholders have not this right, writing down ordinary shares is no sacrifice. To make an equitable adjustment which will involve a sacrifice on the part of the ordinary shareholders, the holders of the reduced

preference shares may be given the right to share in surplus, or part of their holdings may be converted into ordinary shares.

Great care must be taken not to impose an inequitable sacrifice on the preference shareholders. The good of the company as a whole, preserving the rights of all so far as possible, must be the determining factor.

Where there are arrears of preference dividends, it may be necessary to include some compensation for the sacrifice thereof in the amount offered to the preference shareholders. In some cases, however, the preference shareholders will be willing to sacrifice their rights in this respect for the prospect of immediate dividends which will enhance the value of their shares.

Very often, a cause of anxiety is working capital, and provision therefor has to be made in the reconstruction. Before deciding on the scheme, the alternative methods of providing this have to be thoroughly explored, viz.—

(1) An issue of further shares. This will not be possible as a rule until the scheme has been effected, so that the prospective applicants can see that the company's finances are healthy.

(2) Creation of bonds, borrowing on loan or overdraft, obtaining longer credit from suppliers, shortening credit for debtors, etc. These again normally must follow the reorganization.

(3) Forming a new company to take over the business, the shares in the new company issued in exchange for the existing shares being partly paid, so that a call can immediately be made. (See Chapter XII.)

Where a new company is to be formed, the procedure is under Section 234 of the Companies Act, 1929, which provides that when a company is proposed to be or is in the course of being wound up *voluntarily* the liquidator may, with the consent of a *special resolution*, sell the whole or part of the undertaking for shares, etc., in another company.

Any member who did not vote in favour of the resolution may express his dissent to the liquidator—

(*a*) in writing, addressed to him at the company's registered office;

(*b*) within seven days of the passing of the special resolution;

(*c*) calling upon him either to abstain from carrying into effect the resolution, or alternatively to purchase his interest at a price determined by agreement or by arbitration. (S. 234.)

(As compared with this, note that in a Reduction of Capital under Section 55 of the Act, *all shareholders*, whether they voted for the resolution or not, are bound by the scheme, when once it has been sanctioned by the Court.)

Where the liquidator agrees to purchase the interests of the dissentient members he will raise the money in such manner as is determined by special resolution and must pay over the money before the company is dissolved.

The following are typical examination questions.

Illustrations. (1) *The Balance Sheet of B & Co. Ltd., at 31st December, was as follows—*

Liabilities	£	*Assets*	£
Share Capital—		*Freehold Property (Works), Plant*	
Authorized and Issued:		*and Machinery at cost*	2,511,130
600,000 7% *Cum. Pref.*		*Stocks*	355,210
Shares of £1 each	600,000	*Debtors*	124,320
3,000,000 *Ord. Shares of £1*		*Investments*	696,080
each	3,000,000	*Cash*	2,550
Creditors	747,650	*Profit and Loss Account—*	
Reserve	705,060	*Loss brought forward* £1,823,060	
Bank	119,640	*Less Profit for year* 340,000	
			1,483,060
	£5,172,350		£5,172,350

The market value of Investments was £750,000.

The Preference dividend was in arrear for two years.

You are requested to prepare a Capital Reduction Scheme for consideration by the Board. Draft your Report.

16 Coleman Street,
E.C.2.

The Directors, 30*th October* 19...
B & Co. Ltd.,
123 Grand Street, E.C.

Gentlemen,

As requested, we have pleasure in submitting hereunder for your consideration a suggested scheme for the reduction of the capital of your company.

1. The ordinary shares to be reduced to 10s. each fully paid, thus making available the sum of £1,500,000 to be used in reduction of assets and other debit balances as shown hereunder.

2. The preference shareholders to be asked to make no capital sacrifice as we understand that they have priority as to return of capital in the event of liquidation, although they are not entitled to share in any surplus arising thereon. The whole of the capital loss thus falls to be borne by the holders of the ordinary shares, but it is suggested that the preference shareholders should be asked to waive their arrears of dividend in consideration of the prospect of the immediate resumption of dividends made possible by the reduction scheme. As this involves a loss of £84,000 to

the preference shareholders it is suggested that as compensation the rate of dividend on their shares should be increased to 7½ per cent.

3. The investments to be written up to their present value of £750,000, the profit of £53,920, thus disclosed, being used towards the reduction in the book value of other assets. The whole of the Reserve should also be applied to the same purpose.

4. The adoption of the above suggestions will make available the sum of £2,258,980 to be used in the reduction of the book value of assets and the elimination of the debit balance on Profit and Loss Account. This sum is made up as under—

	£
Reduction of Ordinary Share Capital . . .	1,500,000
Increase in Value of Investments	53,920
Reserve	705,060
	£2,258,980

5. It is suggested that the above sum be applied as follows—

	£
To the elimination of the Debit Balance of Profit and Loss Account	1,483,060
To the reduction in the Book Value of Freehold Property, Plant and Machinery	775,920
	£2,258,980

Yours faithfully,

(2) On 31st December the A Co. Ltd. had the following capital, all in shares of £1 each—

	Authorized £	*Issued* £
5% *Cum. First Preference Shares* . .	60,000	45,000
6% *Cum. Second Preference Shares* .	20,000	20,000
Ordinary Shares	50,000	40,000

On the date mentioned the Goodwill stood at £30,000 and there was a debit balance on Profit and Loss Account amounting to £20,000, both of which it is desired to eliminate from the Balance Sheet. The dividend on the First Preference had been paid regularly until two years ago, and the dividend on the Second Preference until four years ago.

You are requested by the directors of the company to advise as to the basis on which a scheme of reduction of capital should be put before the various classes of shareholders.

Set out your views in the form of a report to the directors, giving reasons for the suggestions you make.

Note. It has been assumed, for the purpose of the following answer, that the Memorandum and Articles of Association of the company expressly provide that—

(*a*) Neither class of Preference Share shall carry any voting rights, unless the dividends are six months or more in arrear;

(*b*) The First Preference Shares shall be preferential as to repayment of capital over all other classes of shares;

(*c*) The Second Preference Shares shall be preferential as to repayment of capital over the Ordinary Shares; and that

(*d*) Neither class of Preference Shares shall carry a right to participation in a surplus remaining on a winding up of the company.

It has also been assumed that, as is usual in such cases, reserves have been drawn upon in certain years to meet the preference dividends.

16 Coleman Street,
London, E.C.2.
27th November, 19...

The Directors,
A Company, Ltd.,
101 Green Street, E.C.2.

Gentlemen,

As requested, we have set out hereunder for your consideration our suggestions for a scheme of reduction of capital to be put before the various classes of your shareholders.

Losses, etc., to be written off.—In addition to providing for the Profit and Loss Account balance of £20,000, we understand that you are desirous of eliminating from the Balance Sheet the whole of the goodwill of £30,000, making a total of £50,000 by which the capital of the company is to be written down.

Allocation of Loss between various Classes of Shares.—Since neither class of Preference Shares carries the right to participate in any surplus arising on the liquidation of the company and both classes are entitled to repayment of capital, on a winding-up, in priority to the Ordinary Shares, the above loss falls to be borne primarily by the Ordinary Shareholders. This, however, would have the effect of eliminating the Ordinary

Capital altogether, a course to which the Ordinary Shareholders could not be expected to subscribe, since they have sacrificed more than is apparent on the face of the Balance Sheet owing to the utilization for the payment of preference dividends of reserves which were built up in past years out of divisible profits.

Although the 1st Preference Shares have priority as to repayment of capital in a winding-up, it must be borne in mind that after the reduction, they will have the benefit of the prospect of immediate dividends and the market value of their shares will be thereby improved, whereas if no reduction is made, they will receive no dividends until the whole of the debit balance on Profit and Loss Account is made good. In addition, if the company decided to write off goodwill out of future profits before declaring dividends, this would extend the period which would have to elapse before dividends could be paid.

It is therefore suggested that, although the loss must be borne primarily by the Ordinary and secondly by the Second Preference Shareholders, the First Preference Shareholders should be asked to make some capital sacrifice in return for the advantages which will accrue to them from the writing off of the losses, and, further, that in order to relieve the company of part of its present burden in the form of cumulative preference dividends, ~~the preference~~ shareholders should be invited to accept part of their reduced capital in the form of Preferred Ordinary Shares, ~~carrying the right to one-half of the profits available for~~ dividend (after payment of the ~~dividend on the 1st and 2nd Cumulative~~ Preference Shares) up to a maximum of 10 per cent.

The following proposals for the reorganization of the capital are therefore submitted—

(1)

	£
The 40,000 £1 Ordinary Shares to be written down by 19s. per share	38,000
The 20,000 6% £1 Second Preference Shares to be written down by 7s. 6d. per share	7,500
The 45,000 5% £1 First Preference Shares to be written down by 2s per share	4,500
	£50,000

(2) The First Preference Shares to accept in respect of each reduced share of 18s.—

One 5% First Cumulative Preference Share of 15s.

Three Preferred Ordinary Shares of 1s. each.

The Second Preference Shares to accept in respect of each reduced share of 12s. 6d.—

One 10% Second Cumulative Preference Share of 7s. 6d.
Five Preferred Ordinary Shares of 1s. each.

The issue of Preferred Ordinary Shares will result in the preference shareholders receiving a share in the equity of the business as a measure of compensation for their capital sacrifice, and will enable them, should the company prosper, to participate in the profits in such a way as to make good the loss of preference dividend entailed by the reduction in the nominal value of their preference shares.

Although it is true that at the moment the preference shareholders have voting rights owing to their dividends being in arrear, it is considered that, on a dividend paying basis, the ordinary shareholders should retain voting control.

Accordingly, the Preferred Ordinary Shares should be consolidated into shares of £1 each, carrying one vote per share, with the right to participate with the Deferred Ordinary Shares on a share per share basis in any surplus arising on the winding-up of the company.

(3) The Ordinary Shares to receive one Deferred Ordinary Share of 1s. each for each £1 Ordinary Share now held.

(4) All arrears of Cumulative Preference Dividends to be cancelled.

(5) The following statement shows the composition of the reorganized capital, together with a comparison of the division, of a hypothetical profit of £5,000 on the basis of the present and the new capitals respectively.

Existing Capital	*Share of Profit* £	s.	d.	*Reorganized Capital*	*Share of Profit* £	s.	d.
45,000 5% First Pref. Shares of £1 each	2,250	0	0	45,000 5% First Pref. Shares of 15s. each	1,687	10	0
				6750 Preferred Ord. Shares of £1 each—Dividend at 10% .	675	0	0
	£2,250	0	0		£2,362	10	0
20,000 6% Second Pref. Shares of £1 each	1,200	0	0	20,000 10% Second Pref. Shares of 7s. 6d. each. .	750	0	0
				5,000 Preferred Ord. Shares of £1 each—Dividend at 10% .	500	0	0
	£1,200	0	0		£1,250	0	0
40,000 Ord. Shares of £1 each —Balance available for Dividend . . .	£1,550	0	0	40,000 Ord. Shares of 1s. each —Balance available for Dividend	£1,387	10	0

We shall be glad to give you any further information you may require.

Yours faithfully,

Chartered Accountants.

(3) *A company owning an engineering business has passed through a period of heavy operating losses. Its Balance Sheet at 30th June may be summarized as follows—*

	£		£
Share Capital authorized and issued—		*Goodwill at cost*	10,000
100,000 6% *Cum. Pref. shares of £1 each*	100,000	*Works and Plant at cost less depreciation*	110,000
130,000 *Ord. Shares of £1 each* .	130,000	*Stock, Work-in-progress, Book Debts, Cash, less trade liabilities* .	31,000
(*Note. The Cumulative dividend on the Preference shares is 5 years in arrear*).		*Debit balance on Profit and Loss Account*	79,000
	£230,000		£230,000

Each share (both Preference and Ordinary) carries one vote. On a liquidation the Cumulative Preference Share Capital is repayable at par plus any arrears of dividend, and any surplus goes to the Ordinary shareholders.

It is considered that the business has now turned the corner, and a recapitalization (involving a reduction in the nominal amount of the Issued Share Capital) is desired. It is believed that the net profits in future will average £12,000 per annum. The floating assets, less liabilities, are considered to be worth the book figure of £31,000; the Goodwill is considered to be valueless; the Works and Plant are regarded as having a value, under existing conditions, of £101,500.

Reframe the Balance Sheet as it would appear after giving effect to such a recapitalization as you consider would commend itself both to the Preference and the Ordinary shareholders under the foregoing circumstances. State how the rights of each class of share would be altered under the scheme you propose; and set out briefly the reasons why you consider that

the scheme would operate equitably between the two classes.

REFRAMED BALANCE SHEET AS AT 30TH JUNE

	£		£
Share Capital:		Work and Plant at cost, *less* Depreciation and Amounts Written Off	101,500
Authorized—		Stock, Work-in-Progress, Book Debts, Cash, *less* trade liabilities	31,000
50,000 8% Pref. Shares of £1 each	50,000		
480,000 Ord. Shares of 7s. 6d each	180,000		
	£230,000		
Issued—			
50,000 8% Pref. Shares of £1 each	50,000		
180,000 Ord. Shares of 7s. 6d. each	67,500		
	117,500		
5% Income Bonds (repayable out of profits by annual drawings over six years)	15,000		
	£132,500		£132,500

The Preference Shareholders receive one fully-paid 8 per cent Preference Share of £1, one fully-paid Ordinary Share of 7s. 6d., and one 6s. 5 per cent Income Bond for every two shares formerly held. The Income Bonds are in respect of one-half the arrears of Preference Dividend.

The Ordinary Shareholders receive one fully-paid Ordinary Share of 7s. 6d. for every share held. Each share carries one vote, but the Preference Shares are preferential as to capital.

Whereas, formerly, the Preference Shareholders were entitled to the first £6,000 of profits, they will now be entitled to the first £4,000 and (subject during the first six years to the payment of Income Bonds) to a share in any surplus profits. In a winding-up, they will be entitled only to priority in respect of one-half the amount formerly attachable to their holdings, but will be compensated (*a*) by the right to share in surplus profits earned,

and (*b*) by the right to share in surplus on a winding-up.

On the basis of £12,000 profit in the first year, the division will be—

	£
Interest on Income Bonds	750
Transferred to Reserve *re* Repayment of Income Bonds	2,500
Dividend on Preference Shares	4,000
Available for Dividend on Ordinary Shares . .	4,750
	£12,000

This would enable the company to pay a dividend of, say, 7 per cent on the Ordinary Shares, i.e. £1,312 10s. to the former Preference Shareholders in respect of their new holding of Ordinary Shares.

In a full year, after the Income Bonds have been repaid, the division will be—

	£
Dividend on Preference Shares	4,000
Available for Dividend on Ordinary Shares . .	8,000

This would enable the company to pay a dividend of, say, 11 per cent on the Ordinary Shares, i.e. £2,062 10s. to the former Preference Shareholders in respect of their new holding of Ordinary Shares.

The Preference Shareholders had no prospects of dividends until the debit balance on Profit and Loss Account was extinguished out of future profits, and their shares must therefore have stood at a discount on the market. On the other hand, the Ordinary Shareholders would have received no dividends for a still longer period, owing to the arrears of preference dividend, and the major part of their capital had, in fact, been lost.

Although the Preference Shareholders had not

yet lost any of their capital, they should make some capital sacrifice in return for immediate income, in addition to discounting the arrears of income, for which they would otherwise have to wait. For that reason, the whole loss should not be borne by the Ordinary Shareholders.

The scheme is therefore considered to be equitable, in the absence of further information as to the profits earned in the past, the rewards already had by the Ordinary Shareholders, and the market values of the shares.

It has been assumed that, under the Articles, the Preference Shares carry no right to participate in any surplus on a liquidation.

CHAPTER XI

THE VALUATION OF SHARES

General considerations—Valuation for amalgamation—Valuation for Estate Duty purposes

It is not necessary to say anything here about shares quoted on a Stock Exchange, but where shares are not so quoted, their valuation presents certain difficulties, which must be explained.

GENERAL CONSIDERATIONS

Certain general considerations must be taken into account, viz.—

(1) The amount of the average profits of the company that can be expected to be earned, having regard to the trend of profits in the past and adjusting for any known facts or contingencies that may cause variations in the future.

(2) The amount required to satisfy dividends on shares having a priority to those in question.

(3) The amount which is considered necessary to set aside each year for the maintenance of reserves.

(4) The amount of the average profits available for distribution to holders of the class of shares in question, having regard to the above.

(5) The yield that would be required from shares of the class being valued in order to maintain them at par. As already explained in connexion with goodwill, there is a minimum return required by an investor before he is willing to pay the face value of an asset. This minimum yield can usually

be arrived at from a scrutiny of the prices at which similar shares are quoted on the Stock Exchange; taking into account a number of similar concerns having a quotation, e.g. if it is found that £1 shares in such concerns, paying a dividend of 6 per cent, are quoted at 24s., it may be assumed that the yield required to maintain them at par would be $\frac{20}{24}$ of 6 = 5 per cent.

Allowance must be made, however, for the extent to which capital is represented by assets of a tangible nature; the consistency with which dividends have been paid; any bonuses declared or expected; the basis of valuation of assets and their nature; the trend of interest rates; how far the dividends are covered by the available profits; the adequacy of specific reserves; the nature and extent of secret reserves, etc. These are factors which can only be appreciated after considerable experience, and in default of such experience, the valuer should seek skilled advice. The speculative element in published prices is sometimes difficult to gauge.

(6) The effect of the severance of the connexion with the business of a skilled executive. The continuation of the present management may be all important.

(7) The value of any office of profit attaching to the holding.

(8) Any anticipated changes in legislation, e.g. safeguarding, tariffs, etc.; changes in demand or fashion.

(9) The extent of loan capital and the necessity of providing redemption funds.

(10) The voting power attached to the shares,

and any special provisions in the Memorandum or Articles of Association.

When due regard has been paid to the above considerations, the investment value of the shares can be ascertained from the following formula—

$$\frac{\text{Average dividends expected}}{\text{Yield expected}} \times \text{par value.}$$

Example. *A £1 share is expected to yield* 6 *per cent to maintain it at par. The actual yield which can be anticipated is* 8 *per cent.*

The value of the share is therefore

$$\frac{8}{6} \times £1 = £1\ 6s.\ 8d.$$

VALUATION FOR AMALGAMATION

In the valuation of shares for the purposes of amalgamation, however, the "asset basis" is frequently adopted, the procedure being as follows—

(1) Revalue the tangible assets—

(*a*) Fixed assets at their value to the business as a going concern.

(*b*) Investments at current market value.

(*c*) Stock-in-Trade at current market buying or replacement value.

(*d*) Other floating assets—debtors, bills, etc.—at estimated realizable value, after deducting reserve for bad debts.

(2) Value the goodwill (see Chapter IV).

(3) From the total of (1) and (2) deduct the external liabilities.

(4) The resultant amount is then regarded as the total value of the share capital. Any shares

carrying fixed dividends must be valued on a yield basis (allowance being made for unearned dividends), and deducted, the balance representing the value of the ordinary capital.

It must be emphasized, however, that it may be impracticable to value tangible assets separately from the goodwill, as there are many instances where the earning capacity of the business as a whole is the only criterion of worth, e.g. the factory and plant may be suitable only for that particular business, and are therefore so interwoven with goodwill that to attempt to separate them would be absurd. In that case, a yield basis is the only satisfactory method of valuation.

Illustration of Asset Basis of Valuation. *A company has an issued share capital of* 100,000 *£*1 *Ordinary Shares and* 100,000 6 *per cent £*1 *Preference Shares. The average profits of the company for the past seven years were £*25,600, *and this is the figure expected to be maintained. For the purposes of an amalgamation, the assets were revalued as follows—*

	£
Fixed Assets	160,000
Investments	10,000
Stock	70,000
Debtors	50,000
Bills Receivable	5,000
Cash at Bank and in Hand	22,000
Total Tangible Assets	£317,000
Goodwill (see below)	47,800
	£364,800
Deduct: *Liabilities*	54,000
Total Value of Share Capital	£310,800
Deduct: *Preference Share Capital (see below)*	103,000
Value of Ordinary Share Capital	£207,800

Each ordinary share is thus worth

$$£\frac{207,800}{100,000} = £2 \text{ 1s. 7d.}$$

and the ordinary shareholders should receive shares or other interests in the new or absorbing company equal to £2 1s. 7d. for every share now held.

Goodwill.

			£
Average Maintainable Profits			25,600
Deduct: Amount required to pay Preference Dividends			6,000
			19,600
Deduct: (assuming 8% to be a fair return to maintain ordinary shares at par) 8% on net capital employed attributable to ordinary shares, viz.—			
Tangible assets (as above) .		£317,000	
Less Liabilities . .	£54,000		
Preference Capital .	103,000		
		157,000	
8% on		£160,000	12,800
Average Super Profits			£6,800

At, say, seven years' purchase of Super Profits, Goodwill is worth £47,600.

The Preference Shares have been valued at par on the assumption that 6 per cent is the current yield expected. To this has been added six months' dividend accrued.

It is interesting to compare the "yield basis" in the above case.

The profits available for the ordinary shareholders amount to £19,600 (subject to reserves). This would enable a dividend of 19·6 per cent to be paid. Since 8 per cent has been assumed to be the yield expected, each share would be worth

$\frac{19 \cdot 6}{8}$ of £1 = £2 9s. If, however, say 10 per cent of the profits were set aside for reserve (and this is not an excessive amount), the position would be—

		£
Profits		25,600
Less Transfer of 10% to Reserve . .	£2,560	
Preference dividend	6,000	
		8,560
Available for Ordinary dividends . .		£17,040

This is equivalent to 17·04 per cent, and the shares would be worth $\frac{17 \cdot 04}{8}$ of £1 = £2 2s. 7d.

In some cases, a valuation is made on both bases, and a "mean" struck; this, however, has little to recommend it, and a more conservative method is to take the lower of the two valuations.

VALUATION FOR ESTATE DUTY PURPOSES

Where shares have to be valued for Estate Duty purposes, other considerations dictated by statute or case decisions must be taken into account. This, however, is outside the scope of this work.

Illustration. *The following is the Balance Sheet and Profit and Loss Appropriation Account of a private limited company as at 31st December—*

Balance Sheet

	£		£
Share Capital Authorized and Issued:		*Land and Buildings*	6,000
4,000 6% Pref. Shares of £1 each, fully paid	4,000	*Plant and Machinery*	3,000
2,000 Ord. Shares of £1 each, fully paid	2,000	*Patent Rights*	1,000
General Reserve	1,000	*Stock-in-Trade*	2,500
Sundry Creditors	400	*Debtors*	4,000
Profit and Loss Account . . .	12,000	*Cash in Hand and at Bank* . .	2,900
	£19,400		£19,400

Profit and Loss Appropriation Account

		£			£
Mar. 31.	To 6 months' Dividend on Pref. Shares	120	Jan. 1.	By Balance	4,000
	" Final Dividend of 200% on Ord. Shares	4,000	Dec. 31.	" Profit for Year	14,240
Sept. 30.	" Interim Dividend of 100% on Ord. Shares	2,000			
	" 6 months' Dividend on Pref. Shares	120			
Dec. 31.	" Balance, per Balance Sheet	12,000			
		£18,240			£18,240

The directors recommend the payment of a final dividend of 200 per cent, making 300 per cent for the year.

The profits for the previous two years were £11,180 and £12,200 (respectively).

Under the Articles of Association the Ordinary Shares can only be transferred at a valuation to be certified by the company's auditor. Prepare a valuation at 31st December.

Solution. The following general considerations must be taken into account in valuing the shares of a private limited company.

(*a*) The amount of the average maintainable profits of the company as disclosed by past accounts, adjusted where necessary to give effect to any known facts or contingencies which may cause the future profits to diverge from the past average.

(*b*) The dividends payable by the company on shares possessing dividend rights in priority to those now to be sold.

(*c*) The amounts which it is considered desirable to withhold from distribution as dividend each year in order to create and maintain necessary reserves.

(*d*) From (*a*), (*b*), and (*c*), *supra*, the amount of the average profits available for distribution to the holders of shares of the class held.

(*e*) The average yield expected to be obtained from shares of the same class in similar undertakings quoted on the Stock Exchange. In this connection, the extent to which the capital is represented by assets of a tangible nature, and the consistency with which dividends have been paid, would be taken into account.

The investment value of the shares will then be ascertained by the following formula—

$$\frac{\text{Average dividends payable}}{\text{Yield expected}} \times \text{par value.}$$

In certain circumstances it would also be necessary to have regard to the following—

(i) Where the shares to be sold were owned by a deceased shareholder, who took an active part in the management of the business, the effect of his death on the earnings of the business.

(ii) The extent to which control of the company will be obtained by the persons to whom the shares are offered.

(iii) The value of any office of profit with the company which will be obtained by the holder of the shares.

(iv) The possibility of an early bonus distribution out of profits held in reserve.

In the case given it would appear that it has been necessary for the company to retain in the business a considerable proportion of the profits earned during the last year. After the payment of the proposed final dividends on the ordinary shares, a balance of £8,000 will remain on Profit and Loss Account the whole of which would presumably be required to provide necessary working capital. It

is difficult, on the facts given, to ascertain what has been the position in past years. The profits for the previous two years aggregate £23,380, yet a balance of only £4,000 remained on the Appropriation Account at 1st January, thus indicating that a dividend has been paid on the ordinary shares of at least 500 per cent per annum.

The fixed assets at 31st December exceed the share capital and general reserve by £3,000, and it would thus appear that unless a considerable proportion of these assets was acquired during the year the company has been under-capitalized in the past.

The average earnings of the past three years, after providing for the preference dividend, represent over 600 per cent on the ordinary capital, and have shown a progressive increase.

Without some regard for the proportion of profits earned which must in future be left in the business to provide necessary working capital and reserves, however, it is impossible to arrive at an estimate of the rate of maintainable dividends. On the basis of the three years it would appear that the dividends on the ordinary shares have averaged approximately 400 per cent per annum.

The large profits earned in relation to the capital employed in the company suggest that the business is of a very speculative character and having regard to the risk thus involved a return of, say, 10 per cent on capital would not appear to be excessive. On this basis and assuming that an average dividend of 400 per cent per annum can be maintained the ordinary shares are worth 400/10 of par = £40 per share.

CHAPTER XII

AMALGAMATIONS

METHODS of amalgamation—Advantages—Accounting entries—Relief from Stamp Duty

THE term amalgamation as applied to companies embraces all mergers of interests, whether partial or complete. We are not concerned here with those mergers which do not affect the accounts, e g. trade associations, cartels, trusts, etc., but rather with amalgamations of separate businesses into larger entities.

Where one existing company is expanded to take over the businesses of others, the amalgamation is usually referred to as an "absorption," since one company absorbs the others. Frequently, however, absorption is not convenient, and a new company is formed to take over all the existing businesses.

Either of the above methods involves the loss of the identity of each business taken over, with the corresponding loss of goodwill attached thereto. Where this would be serious, it is more usual to combine the interests of the businesses concerned by means of the formation of a holding company which acquires a controlling interest in the individual businesses, which then continue as separate entities, run for the benefit of the combine as a whole. (See Chapter XIII.)

A merger sometimes takes the form of a pooling arrangement without any amalgamation of assets. In such cases, quotas are fixed for each concern,

and a controlling executive arranges for the payment into the central pool of excess profits, etc., of those concerns that exceed their quota, such excess being shared rateably among the concerns that keep inside their quotas. The pooling may extend to profits, orders, and/or production.

The problems arising in a pooling agreement hardly come within the scope of this work, and it is proposed in this chapter to deal only with what may conveniently be termed "complete amalgamations," i.e. where there is a merging of assets and liabilities, the separate businesses ceasing to exist.

METHODS

An amalgamation may be either "horizontal" or "vertical."

A horizontal amalgamation is one where the businesses merged are all carrying on the same type of business in competition with each other, e.g. a merger of steel manufacturers.

A vertical amalgamation is one where the businesses merged form a chain of operations, each having formerly been engaged in a different stage of production, and acted as a "feeder" of the next in the chain, e.g. a merger of the five businesses which formerly, respectively, (*a*) extracted ores from the ground, (*b*) conducted the blast furnaces, (*c*) converted the iron into steel, (*d*) manufactured the steel into steel goods, (*e*) transported and distributed the goods.

ADVANTAGES OF AMALGAMATION

The advantages of amalgamations may be summarized as follows.

Buying (Materials, Plant, etc.).

The unification of buying departments and staffs increase efficiency with economy.

Bulk purchases enable better prices and discounts to be obtained than are possible with detail purchases. Large buyers can even dictate to suppliers the patterns and standards of goods to be supplied. Supply can also be assured; suppliers will usually store for large purchasers reserve stocks required to ensure steady deliveries.

Credit is improved and cheapened.

Greater opportunities arise for comparison and selection.

Manufacturing

Products can be standardized.

Factories can specialize in those products for which they are best adapted. (A small concern may have to make articles for which its factory is not truly suitable, in order to be able to offer a complete "range," whereas the combine can complete its range by drawing on its several factories.)

Production can be concentrated in the best factories. It is not infrequently found economical to close down inefficient factories, the additional profits accruing to the remainder being more than enough to pay the interest on the capital thus employed. It is always more economical to have fewer works producing regularly than a greater number intermittently. Plant can be improved. The capital at the command of the combine makes possible expenditure beyond the resources of the smaller business. Obsolete plant can be replaced.

Use can often be found for by-products, owing

to the practicability of installing an adequate research department. Advantage can be taken of new processes and inventions.

Work can be better distributed, to maintain the output of various factories. Working to economic capacity is profitable.

Quality can more readily be maintained.

Selling and Distribution

The unification of selling departments and staffs will produce increased efficiency and economy. Competition will be rationalized; over-lap of territories stopped; advertising done collectively, etc.

Markets will be broadened, e.g. the export market extended and fewer middlemen required. Price-cutting will disappear. Through control of supply, prices may be controlled to a certain extent at least; any competitors may be willing to agree to minimum prices, owing to the strength of the big concern.

Costs of distribution and transport should be lowered, central depots can be installed and "cross-freights" eliminated, e.g. whereas business X formerly delivered to destinations near factory Y and factory Y to places near business X, in future all deliveries will be made from the nearest centre, no matter where the order is received.

Patent rights, special brands, and trade-marks formerly available only to individual businesses can be used by the combine.

Knowledge

Data and experience can be interchanged.

Costings can be standardized and compared.

Trade statistics can be collected and disseminated.

Scientific and technical research can be promoted.

Financial

The larger concern should find capital to be more readily obtainable, and correspondingly obtainable more cheaply. Public issues may be made possible.

Destructive competition is eliminated; it is not unusual to find that a concern which was financially or technically embarrassed can carry on as a valuable constituent of a combine associated with stronger and better managed concerns.

General

In brain power alone, the combine is at a considerable advantage. The small business cannot afford the best men; the large one cannot afford to be without them, but can attract them, owing to its resources being sufficient adequately to remunerate them. This applies in all departments.

DISADVANTAGES

The main drawbacks of amalgamations are—

(1) The tendency to raise prices where a quasi-monopoly results. This drawback is rarely serious, as inevitably new concerns will spring up to take advantage of the high prices obtainable for the products or to introduce substitutes, resulting in competition again. Moreover, it is now realized that more and steadier profits are to be gained by a large market at a fair price than by a limited market at an unfair price.

(2) The initial unemployment that may arise owing to the discharge of redundant staff.

(3) The dangers of the introduction of "red-tape" methods, killing initiative and enterprise.

(4) The large concern makes possible speculation and over-capitalization.

(5) The dangers of the introduction of unfair methods of competition, e.g. price-cutting to eliminate small competitors, discriminatory prices, rebates to "tie" retailers, etc.

(6) Where the business is personal, the loss of contact may have prejudicial effects on goodwill.

(7) Some amalgamations are founded, not on any preconceived general benefit to the businesses involved, but merely for the purpose of enabling certain individuals to become "big business men." When this arises (which, fortunately, is not often) it is very serious, since such men are unlikely to prove the right managers for the new concern.

The detailed considerations that arise before and during the course of an amalgamation are many, and call for very careful consideration, e.g. the date from which it is to operate, valuation of assets and ascertainment of liabilities to be taken over, valuation of goodwill, capitalization, the basis for exchanging shares in the new company, etc. These are not a matter of accounting, however, and we must now turn our minds to the accounting that arises on an amalgamation.

Readers should be quite well aware of the fact that "profits are assets." Where there is an amalgamation, any undistributed profits of the vending businesses do not therefore reach the purchasing company as such, but simply as assets.

Any balances on Profit and Loss Account or Reserve Accounts of the vending concerns therefore disappear; the purchasing company cannot commence with profits taken over.

The basis of valuation of shares has been dealt with in Chapter XI. Where a business is being taken over from a partnership or sole trader, similar principles must be adopted to arrive at the purchase consideration. On an amalgamation, another factor arises, that it may be necessary to make some slight addition to the real value in order to obtain the sanction of the proprietors to the scheme. Such a concession, of course, must not be so great as to prejudice the new concern.

To appreciate the method of accounting, it is well to understand how the exchange of shares is effected. The following illustration should make this clear—

Illustration. *The N Co. Ltd. was formed for the purposes of amalgamating the businesses of A Ltd. and B Ltd.*

The revalued assets other than Goodwill of these two companies were £14,000 *and* £20,000 *respectively, and the liabilities* £4,000 *and* £5,000. *Each company had a fully paid-up share capital of* 12,000 £1 *shares.*

On valuing the goodwills, it was found that the shares of A Ltd. were worth 21s. *and those of B Ltd.* 25s.

If N Co. Ltd. is to take over all the assets and liabilities of the two companies in exchange for shares, it will therefore allot to the shareholders of A Ltd. shares to the value of 12,000 × 21s. = £12,600, or twenty-one £1 shares in N Co. Ltd. for each twenty £1 shares in A Ltd.; and to those

of B Ltd. twenty-five £1 shares in N Co. Ltd. for every twenty £1 shares in B Ltd.

Fractions of holdings would inevitably arise, and to avoid these it may be desirable to make the shares in N Co. Ltd. 1s. each, so that there will be allotted to the shareholders of A Ltd. twenty-one 1s. shares for each £1 share now held, and of B Ltd. twenty-five 1s. shares for each £1 share now held.

Alternatively, of course, each old shareholder may be allotted the complete shares to which he is entitled, the fractions being allotted to the liquidator of A Ltd. or B Ltd., respectively, to be sold and the proceeds distributed to those entitled to the fractions. Sometimes fractional rights' certificates are issued to the shareholders entitled to the fractions, leaving them to sell or buy fractions until they have sufficient fractions to make up a whole share, in exchange for which they will be handed a share certificate. Again, partly-paid shares may be allotted, the shareholders receiving them agreeing to make the shares fully paid.

In those cases where further working capital is required, the shares in the new company can be issued as partly paid, enabling the directors to make a call forthwith and thus place the company in funds. Obviously, the old company's shareholders will only agree to this where the consideration is fair, and the old company short of working capital, or the prospects are attractive enough to indicate to them a substantial increase in returns.

ACCOUNTING ENTRIES

The entries involved in the books of account are very simple. The company, the business of which

is being taken over, has to close its books; the new company to open its books. If it is an absorption, the purchasing company takes into its existing books the assets and liabilities that are acquired.

The rules for closing the old company's books are as follows—

(1) Transfer to Realization Account the assets and liabilities that are being taken over.

(2) Open a "Sundry Members' Account," to which transfer all balances appertaining to the proprietors, i.e. share capital, profit and loss, reserve, reserve fund, preliminary expenses, etc.

(3) In examination work, open accounts for any remaining assets or liabilities. In practice, these accounts are, of course, open.

(4) Compute the purchase consideration; credit it to Realization Account, debiting the purchasing company (in an account opened for it).

(5) Pay any expenses arising; credit Cash, debit Realization Account.

(6) Collect any assets and pay off any liabilities, transferring any profit or loss thereon to Realization Account.

(7) Credit the purchasing company and debit the proper accounts with the items forming the purchase price, i.e. shares, cash, etc.

(8) Balance the Realization Account, transferring any profit or loss on realization to the Sundry Members' Account.

(9) Debit the Sundry Members' Account and credit cash, shares in new company, etc. The books are thus completely balanced off.

For opening the new company's books (or bringing the items into the absorbing company's books, as the case may be)—

Debit accounts with the various assets, and credit liability accounts with the various liabilities taken over, taking the totals to the credit and debit respectively of a "Vendor's Account."

Debit Vendors' Account with the purchase consideration, crediting share capital account(s), debentures, cash, etc., according to the nature of the items making it up.

The balance on the Vendor's Account is then the amount of Goodwill (if Dr.) or Capital Reserve (Cr.), and must be transferred to an account of that name.

In arriving at the amount of the purchase consideration, any shares issued at a premium must be brought into account at the full value; similarly partly-paid shares must come into account at their paid-up value. If this were not done, the true result of the transaction would not be shown in either company's books.

Where there are several classes of shares in the vending company, it may be desirable to open separately a Sundry Members' Account for each class, although it is more convenient simply to have separate columns in one such account. Any ultimate differences in the accounts will be reciprocating. The profit or loss on realization will normally be taken to the class of members entitled to the balance of profits after the preferential dividends have been paid. The point is really only of academic interest, since the rights of the various classes will have been fully explored and taken into

account in arriving at the consideration to be paid to them. Where cash remains as a surplus, however, this must be divided rateably, according to the rights of each class of members, depending upon the Memorandum and Articles of Association.

Illustrations. (1) *The Balance Sheet of X Ltd. was as follows—*

	£			£
Issued Capital:		*Goodwill*		10,000
6% £1 *Pref. Shares*	12,000	*Buildings*		11,000
£1 *Ord. Shares*	8,000	*Plant*		9,000
Debentures	10,000	*Stock*		8,300
Creditors	8,200	*Debtors*	£7,000	
Reserve	8,400	Less *Reserve for Doubtful Debts*	350	
Profit and Loss Account	2,000			6,650
		Bills Receivable		400
		Cash		3,250
	£48,600			£48,600

A new company was formed to acquire all the assets except cash, and to take over the creditors. The consideration was the allotment of eleven 5 per cent Preference Shares of £1 each, fully paid, for each ten Preference Shares held; of twenty Ordinary Shares of £1 each, credited as 18s. paid, for each of sixteen Ordinary Shares held; and of sufficient debentures to enable the existing debenture-holders to be satisfied at a premium of 5 per cent on their holdings by the issue of debentures in the new company.

The expenses of winding-up X Ltd. were £750. The Articles were silent as to the distribution of surplus in winding-up.

Show the entries required to close the books of X Ltd.

REALIZATION ACCOUNT

	£		£
To Sundry Assets:		By Creditors	8,200
Goodwill	10,000	" Purchasing Company, consideration	32,700
Buildings	11,000	" Loss on Realization	6,050
Plant	9,000		
Stock	8,300		
Debtors	7,000		
Bills Receivable	400		
Premium on Debentures	500		
Cash—Expenses	750		
	£46,950		£46,950

SUNDRY MEMBERS' ACCOUNT

	Preference	Ordinary		Preference	Ordinary
	£	£		£	£
To Realization Account, loss on realization		6,050	By Share Capital	12,000	8,000
" New Company Shares	13,200	9,000	" Reserve		8,400
" Cash	1,620	880	" Profit and Loss Account		2,000
" Transfer		2,820	" Reserve for Doubtful Debts		350
			" Transfer	2,820	
	£14,820	£18,750		£14,820	£18,750

DEBENTURE-HOLDERS' ACCOUNT

	£		£
To New Company Debentures	10,500	By Debenture Account	10,000
		" Realization Account	500
	£10,500		£10,500

CASH BOOK

	£		£
To Balance b/f	3,250	By Expenses	750
		" Sundry Members	2,500
	£3,250		£3,250

NEW COMPANY'S ACCOUNT

	£		£
To Realization Account, consideration	32,700	By Sundry Members—	
		Preference Shares	13,200
		Ordinary Shares	9,000
		" Debenture-holders	10,500
	£32,700		£32,700

Notes. (1) Any surplus on realization, after repaying all capital, is divisible rateably between all shareholders, unless the Memorandum and Articles of Association otherwise provide.

The surplus in this case is as follows—

	£
Realization of assets	32,700
Less taken by Debenture-holders . . .	10,500
	22,200
Add Cash, less expenses	2,500
	24,700
Deduct: Amount required to repay share capital .	20,000
Surplus	£4,700

Cash is therefore Divisible—

	£	£
Preference Shareholders $\frac{12}{20}$ths of surplus .	2,820	
Less taken in shares	1,200	
		1,620
Ordinary Shareholders $\frac{8}{20}$ths of surplus . .	1,880	
Less taken in shares	1,000	
		880
		£2,500

(2) The purchase consideration is arrived at as follows—

		£
11 5% Preference Shares of £1 each for each 10 Preference shares held $\frac{11}{10}$ of 12,000 . . .		13,200
20 Ordinary Shares of £1 each, 18s. paid, for each 16 ordinary shares held $\frac{20}{16}$ of 8,000 = 10,000		
10,000 shares, 18s. paid		9,000
Debentures, equal to existing issue .	10,000	
plus 5%	500	
		10,500
		£32,700

(3) Since any profit or loss on the transfer must be borne by the ordinary shareholders (including any benefit which has had to be given to the preference shareholders), the balance on the Preference Members' Account must be transferred to the Ordinary Members' Account.

([illegible]) *Three companies, A, B, and C, propose to sell*

their undertakings for shares in a company to be formed, and supply you with the following figures—

	A	B	C	Total
	£	£	£	£
Fixed Assets, less depreciation	34,500	9,400	11,900	55,800
Liquid Assets:				
Stocks	1,500	3,750	3,400	8,650
Investments (Government Securities)	5,000	2,200	—	7,200
Debtors, less Reserve	6,300	3,050	2,900	12,250
Cash at Bank and in Hand	5,400	2,400	165	7,965
	18,200	11,400	6,465	36,065
Total Assets	£52,700	£20,800	£18,365	£91,865
Capital (paid-up)	27,000	10,000	16,000	53,000
Creditors	1,500	2,200	400	4,100
Profit and Loss (Balance)	24,200	8,600	1,965	34,765
	£52,700	£20,800	£18,365	£91,865
Profit for last year	8,100	4,000	3,200	15,300

The profits for the previous two years were—

	£	£	£
First year	6,750	3,500	4,000
Second year	7,425	3,750	4,400

You are requested to report as to the basis upon which disposal should be effected and as to the capitalization of the new company. Draft your report.

16 Coleman Street,
London, E.C.2.
5th November 19 . . .

Gentlemen,

We have pleasure in reporting as requested as to the basis upon which the undertakings of the three companies, A, B and C, should be disposed of to the proposed new company and as to the capitalization of that company.

(1) Assuming all necessary adjustments to have been made in the valuations of the assets of the respective companies as disclosed by the balance sheets submitted to us, the net capital employed in the business is as follows—

	A	B	C
	£	£	£
Fixed Assets . . .	34,500	9,400	11,900
Liquid Assets (exclusive of Investments) .	13,200	9,200	6,465
	47,700	18,600	18,365
Less Creditors . .	1,500	2,200	400
Net Capital employed .	£46,200	£16,400	£17,965

(2) The average trading profits for the past three years are as follows—

	A	B	C
Year	£	£	£
1	6,750	3,500	4,000
2	7,425	3,750	4,400
3	8,100	4,000	3,200
	3)22,275	3)11,250	3)11,600
	7,425	3,750	3,870(approx.)
Less Income from Investments (assumed yield 3½ per cent) .	175	77	—
Average trading profits .	£7,250	£3,673	£3,870

(3) From inquiries made it would appear that a yield of 8 per cent ought reasonably to be provided on capital employed in businesses of the type carried on by the three companies. On this basis the annual super-profits earned by the companies are—

	A	B	C
	£	£	£
Average trading profits .	7,250	3,673	3,870
Less 8 per cent on capital (employed) .	3,696	1,312	1,437
Super Profits . . .	£3,554	£2,361	£2,433

(4) The goodwill may be based, in the cases of A and B, on five years' purchase of the super-profits and in the case of C (since the profits show a downward trend) on three years' purchase of the super profits.

Assuming the market value of the investments to be that disclosed by the balance sheets, the purchase consideration of the respective undertakings may be computed as follows.

	A	B	C
	£	£	£
Total Assets . . .	52,700	20,800	18,365
Goodwill . . .	17,770	11,805	7,299
	70,470	32,605	25,664
Less Creditors . .	1,500	2,200	400
	£68,970	£30,405	£25,264
Say . . .	£69,000	£30,000	£25,000

(5) If the capital of the new company is to consist of shares of £1 each issued at par, the total consideration will be discharged by the issue of 124,000 shares, to be allocated to the shareholders of the respective companies as follows—

A 69 shares in the new company for every 27 shares in the old company (or 23 for every 9).

B 30 shares in the new company for every 10 shares in the old company (or 3 for every 1).

C 25 shares in the new company for every 16 shares in the old company.

Alternatively, if it is desired to avoid the liability for stamp duty which would be entailed by an increase in capital, the capital of the new company may consist of 53,000 shares of £1 each to be allocated as to—

$\frac{69}{124} \times 53{,}000 = 29{,}500$ (approx.) to the shareholders of A (being 59 new shares for every 54 old).

$\frac{30}{124} \times 53{,}000 = 13{,}000$ (approx.) to the shareholders of B (being 13 new shares for every 10 old).

$\frac{25}{124} \times 53{,}000 = 10{,}500$ (approx.) to the shareholders of C (being 21 new shares for every 32 old).

Yours faithfully,

(3) *The Excel Co. Ltd., and the Sior Co. Ltd., agree to combine and form a new company to be called Excelsior Ltd., with a nominal Capital of £250,000 in £1 shares. The new company takes over the assets and liabilities of both companies, the*

consideration being 150,000 fully-paid shares to the Excel Co. and, to the Sior Co., 50,000 fully-paid shares and £5,000 in Cash.

Formation expenses £3,000 and Liquidation expenses £1,000 are paid by the new company.

The balances at the date of amalgamation were—

	Excel Co.		*Sior Co.*	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£
Share Capital		100,000		50,000
Sundry Assets, less liabilities .	128,645		65,370	
Debentures issued and outstanding				10,000
Cash at Bank	27,605		3,130	
Reserve Account . . .		50,000		5,000
Profit and Loss Account .		6,250		3,500
	£156,250	£156,250	£68,500	£68,500

Assume that the Debentures were paid off and Expenses charged against Reserve. Prepare opening Ledger Accounts and Balance Sheet of the new company, ignoring Subscribers' Shares, and bringing in the assets at the value at which they stood in the books of the original companies.

VENDOR'S ACCOUNT, EXCEL CO. LTD.

	£		£
To Share Capital Account . .	150,000	By Sundry assets, less liabilities .	128,645
„ Capital reserve account . .	6,250	„ Cash	27,605
£	156,250	£	156,250

VENDOR'S ACCOUNT, SIOR CO. LTD.

	£		£
To Cash, debentures paid off .	10,000	By Sundry assets, less liabilities .	65,370
„ Share capital account . .	50,000	„ Cash	3,130
„ Cash	5,000		
„ Capital reserve account . .	3,500		
	£68,500		£68,500

SHARE CAPITAL ACCOUNT

	£		£
To Balance c/d	200,000	By Excel Co. Ltd.	150,000
		„ Sior Co. Ltd.	50,000
	£ 200,000		£ 200,000
		By Balance b/d	200,000

SUNDRY ASSETS, LESS LIABILITIES

	£		£
To Excel Co. Ltd.	128,645	By Balance c/d	194,015
„ Sior Co. Ltd.	65,370		
	£ 194,015		£ 194,015
To Balance b/d	194,015		

CASH BOOK

	£		£
To Excel Co. Ltd.	27,605	By Debenture-holders, Sior Co. Ltd.	10,000
„ Sior Co. Ltd.	3,130	„ Sior Co. Ltd.	5,000
		„ Expenses	4,000
		„ Balance c/d	11,735
	£30,735		£30,735
To Balance b/d	11,735		

CAPITAL RESERVE ACCOUNT

	£		£
To Formation expenses	3,000	By Excel Co. Ltd.	6,250
„ Liquidation expenses	1,000	„ Sior Co. Ltd.	3,500
„ Balance c/d	5,750		
	£9,750		£9,750
		By Balance b/d	5,750

EXCELSIOR LTD.—BALANCE SHEET AS AT——

	£		£
Share Capital:		Sundry assets, less liabilities, at cost	194,015
Nominal, in £1 shares	250,000	Cash	11,735
Issued, 200,000 £1 shares, fully paid	200,000		
Capital reserve	5,750		
	£ 205,750		£ 205,750

(4) *Black and White carried on business as partners, sharing profits and losses equally. Their business was divided into A and B departments, and the following is a detailed copy of their Balance Sheet as on 31st March.*

Liabilities	£	£	*Assets*	£	£
Creditors			*Land and Buildings, at cost*		18,650
A Dept.	15,400		*Fixtures, at cost, less depreciation*		500
B Dept.	2,600	18,000	*Debtors:*		
Loans		1,200	*A Dept.*	6,400	
Bank Overdraft		8,950	*B Dept.*	10,800	17,200
Capital Accounts			*Stock-in-Trade:*		
Black	26,300		*A Dept.*	23,000	
White	16,200	42,500	*B Dept.*	11,250	34,250
			Cash in hand		50
		£70,650			£70,650

As from 31st March it was arranged that the business should be taken over by two limited companies, one called Black & Co. Ltd., to take over A department, and the other White & Co. Ltd., to take over B department. The loan holders agreed to accept 7 per cent Preference Shares of £1 each, fully paid, for their loans, 720 of these being in Black & Co. Ltd., and 480 in White & Co. Ltd.

Black & Co. Ltd., took over the premises, fixtures and cash, and the liability to the Bank.

The assets and liabilities were transferred at the Balance Sheet figures, and the partners were to be paid £5,000 for the goodwill of A department and £4,000 for that of B department.

The whole of the purchase price was satisfied by the allotment of fully paid Ordinary Shares of £1 each in the respective companies as follows—

Black—

23,750 *Shares in Black & Co. Ltd.*

The balance by shares in White & Co. Ltd.

White—

15,920 Shares in White & Co. Ltd.
The balance by shares in Black & Co. Ltd.

The bank overdraft was paid off out of the proceeds of a mortgage of £10,000, which was raised on the land and buildings by Black & Co. Ltd. The costs of the mortgage were £350.

Ordinary Shares, as follows, were issued to employees and paid for in full—

Black & Co. Ltd., 1,000. White & Co. Ltd., 1,500.

The formation expenses, which were payable by the respective companies, were Black & Co. Ltd., £650; White & Co. Ltd., £400.

Set out the Balance Sheets of the new companies after the foregoing transactions had taken place.

BLACK & CO. LTD.

BALANCE SHEET AS AT 1ST APRIL

Capital and Liabilities	£	£	*Assets*	£
Share Capital—			Goodwill at cost	5,000
Authorized:			Land and Buildings at cost	18,650
Issued:			Fixtures at cost	500
720 7% Pref. Shares of £1 each, fully paid	720		Stock-in-Trade	23,000
29,530 Ord. Shares of £1 each, fuly paid	29,530		Debtors	6,400
		30,250	Cash	1,100
Mortgage on Land and Buildings		10,000	Costs of Mortgage	350
Creditors		15,400	Preliminary Expenses	650
		£55,650		£55,650

WHITE & CO. LTD.

BALANCE SHEET AS AT 1ST APRIL

Capital and Liabilities	£	£	*Assets*	£
Share Capital—			Goodwill at cost	4,000
Authorized:			Stock-in-Trade	11,250
Issued:			Debtors	10,800
480 7% Pref. Shares of £1 each, fully paid	480		Cash	1,100
24,470 Ord. Shares of £1 each, fully paid	24,470		Preliminary Expenses	400
		24,950		
Creditors		2,600		
		£27,550		£27,550

(5) *The Balance Sheets of the VD Co. Ltd., for the three years ended 31st December, were as follows—*

	Year 1	Year 2	Year 3
Liabilities—	£	£	£
Share Capital	1,000,000	1,000,000	1,000,000
Creditors	30,000	30,000	30,000
Reserves	200,000	220,000	240,000
Profit and Loss Account	60,000	60,000	60,000
	£1,290,000	£1,310,000	£1,330,000
Assets—			
Buildings and Plant	380,000	400,000	400,000
Debtors	110,000	120,000	80,000
Stock-in-Trade	630,000	620,000	700,000
Goodwill	140,000	140,000	120,000
Cash	30,000	30,000	30,000
	£1,290,000	£1,310,000	£1,330,000
Net Profits, after providing for Depreciation, Taxation and Director's Fees, but before appropriation to Reserves and Dividends	£200,000	£190,000	£250,000

Upon a scheme for amalgamation, the Buildings and Plant and Stocks are to be valued by independent valuers, while Goodwill is to be valued by ascertaining the true capital "employed" in the business during the three years, and the Goodwill calculated upon the super-profits after allowing 10 per cent on the average capital "employed."

The valuations were as follows—

Buildings and Plant	£595,000	£618,000	£620,000
Stock-in-Trade	£650,000	£640,000	£740,000

(*a*) *Adjusting the Balance Sheet figures to those of the valuations, show the capital "employed" during each of the three years, assuming the capital employed at the beginning of the first of the three years to be £1,440,000.*

(*b*) *Ascertain the Goodwill on the basis of seven years' purchase of the average super-profits on the*

10 *per cent basis* (*assuming no adjustment of the profit to have been necessary*).

(*c*) *Show the total value of the business for the purpose of the amalgamation as at 31st December.*

The information given in the question is entirely inadequate for the purpose of finding the true capital employed, inasmuch as no information is given as to terms of credit, turnover of stock, etc. It is obvious that the amounts of stock, debtors, cash and creditors must fluctuate considerably throughout the year.

For the purposes of the following answer it has been assumed that the profits accrue evenly over the year, and that dividends are paid on the last day of each year, and that in the meantime the profits are used in the business. No adjustment is possible in respect of interest on capital locked up in fixed assets. It has been assumed that £20,000 was placed to Reserve in earlier as in current years.

(*a*) *Capital employed.*

	Year 1	Year 2	Year 3
	£	£	£
Share Capital . .	1,000,000	1,000,000	1,000,000
Reserves . . .	200,000	220,000	240,000
Profit and Loss Account	60,000	60,000	60,000
Appreciation in—			
Buildings and Plant .	215,000	218,000	220,000
Stock-in-Trade . .	20,000	20,000	40,000
Average Assets in hand during year in respect of Profits distributed (one-half) . . .	90,000	85,000	105,000
	1,585,000	1,603,000	1,665,000
Less Goodwill . .	140,000	140,000	120,000
Capital employed at end of year . . .	1,445,000	1,463,000	1,545,000
Add Capital employed at beginning of year	1,440,000	1,445,000	1,463,000
	£2,885,000	£2,908,000	£3,008,000
Average for year (half) .	£1,442,500	£1,454,000	£1,504,000

Note. £20,000 has been transferred to reserve each year, and £20,000 credited to goodwill in the third year. Only the balance of profits has therefore been distributed.

(*b*) *Goodwill.*

Average Profits $\frac{£200,000 + £190,000 + £250,000}{3}$.	£213,333
Average Capital employed $\frac{£1,442,500 + £1,454,000 + £1,504,000}{3}$ = £1,466,833	
10% thereon	146,683
Super-profits	£66,650

Goodwill is therefore valued at £466,550, being seven years' purchase.

(*c*) *Total Value of Business as at 31st December*—

	£
Goodwill	466,550
Buildings and Plant . . .	620,000
Stock-in-Trade	740,000
Debtors	80,000
Cash	30,000
	1,936,550
Less Creditors	30,000
	£1,906,550

(6) *The Balance Sheet of X Printing Co. Ltd., at 30th September was*—

	£		£
Authorized Capital—		*Freehold Premises (at Cost)*	16,500
25,000 *Ord. Shares of £1 each* . . .	25,000	*Plant and Machinery, including Type (at Cost less Depreciation)* .	22,650
25,000 6% *Cum. Pref. Shares of £1 each* .	25,000	*Fixtures and Furniture (at Cost less Depreciation)* . . .	1,500
	£50,000	*Motor Vans* . . .	975
Issued Capital—		*Stock*	1,175
25,000 *Ord. Shares* .	25,000	*Debtors*	8,650
20,000 *Pref. Shares* .	20,000	*Bank and Cash Balances*	2,350
Creditors	4,630		
Profit and Loss Account	4,170		
	£53,800		£53,800

The debtors include an amount of £3,300 owing by Trade Journal Ltd., and an investigation of that company discloses the following position—

	£		£
Capital Authorized and Issued—		*Goodwill and Copyrights* .	2,500
1,000 Ord. Shares of £1 each . . .	1,000	*Furniture* . . .	500
5% Debentures . .	1,000	*Advertisement Suspense Account* . . .	1,000
Creditors . . .	4,150	*Debtors*	1,750
Bank Overdraft . .	220	*Profit and Loss Account* .	620
	£6,370		£6,370

An offer is accepted under which X Printing Co. Ltd. agree to purchase all the Debentures at 5s. in the £ and all the shares at 1s. each, the purchase price to be satisfied by the issue of preference shares of X Co.

Show the Balance Sheet of X Printing Co. Ltd., after the arrangement has been completed.

X PRINTING CO LTD.

BALANCE SHEET (after arrangement completed)

	£	£		£	£
Authorized Capital -			Freehold Premises (at cost)		16,500
25,000 Ord. Shares of £1 each . . .	25,000		Plant and Machinery, including Type (at cost less Depreciation). . .		22,650
25,000 6% Cum. Pref. Shares of £1 each .	25,000		Fixtures and Furniture (at cost less Depreciation) .		1,500
	£50,000		Motor Vans . .		975
Issued Capital—			Investment in Subsidiary Company—		
25,000 Ord Shares .	25,000		Shares in Trade Journal Ltd., at cost . .		50
20,300 Pref. Shares .	20,300		Debentures in Trade Journal Ltd., at cost		250
		45,300			
Creditors		4,630	Stock		1,175
Profit and Loss Account .		4,170	Debtors—		
			Amount due by Subsidiary Company . .	3,300	
			Other Debtors . .	5,350	
					8,650
			Bank and Cash Balances .		2,350
		£54,100			£54,100

Note. In view of the position of Trade Journal, Ltd., and of the price at which the debentures and shares in that company have been purchased, it would appear that the recovery

of the debt of £3,300 must be considered as very doubtful, and reserve should be made for the full amount thereof. In the absence of instructions, however, this has not been done.

(7) The following is the Balance Sheet of Phoenix Ltd. as at 31st December—

Capital and Liabilities		£	*Assets*	£
Authorized and Issued Capital—			*Land and Buildings*	25,000
80,000 *Shares of* £1 *each fully paid up*		80,000	*Plant and Machinery*	60,000
5% *Debentures (secured by a floating charge)*	£50,000		*Stocks and Work-in-progress*	23,500
Accrued Interest	2,500		*Sundry Debtors*	24,900
		52,500	*Cash Balances*	2,600
Sundry Creditors		28,500	*Profit and Loss Account*	25,000
		£161,000		£161,000

Note. The fixed assets are valued at cost less depreciation.

The Debentures are held by Excelsior Ltd., who also hold 20,000 shares, acquired during the past two years at a total cost to that company of £14,500.

Negotiations between the two companies resulted in an agreement for the absorption of Phoenix Ltd. by Excelsior Ltd. upon the following terms—

(1) That Excelsior Ltd. take over the assets and liabilities of Phoenix Ltd. as at 31st December at their book figures, subject to the revaluation of the Plant and Machinery at £45,000.

(2) That the amount due in respect of the debentures be set off against the purchase consideration, and that they be cancelled on the completion of the transaction.

(3) That the outside shareholders in Phoenix Ltd. be given £1 shares issued at par by Excelsior Ltd. on the basis of such shares being worth 30s. each and the shares in Phoenix Ltd. being worth 10s. each.

(You are to assume that no fractional holding resulted.)

The arrangement was approved by the necessary

majority of shareholders in Phoenix Ltd. on the following 16th February.

Show the journal entries required to close the books of Phoenix Ltd. and to record the transaction in the books of Excelsior Ltd.—including the transfers required to close the accounts therein relating to the shares and debentures in Phoenix Ltd.

PHOENIX LTD.

JOURNAL

		£	£
Dec. 31	Realization Account . . . . *Dr.*	136,000	
	To Land and Buildings . . .		25,000
	,, Plant and Machinery . . .		60,000
	,, Stocks and Work-in-Progress .		23,500
	,, Sundry Debtors . . .		24,900
	,, Cash Balances		2,600
	Sundry Creditors . . . *Dr.*	28,500	
	To Realization Account . . .		28,500
	Sundry Assets and Liabilities sold to Excelsior Ltd. per agreement approved 16th February.		
	Excelsior Ltd. . . . . . *Dr.*	92,500	
	To Realization Account . . .		92,500
	Agreed purchase consideration. *Note.* It is assumed from the terms of the question that the consideration is the value of the net assets (as revalued), no value being placed on goodwill in view of the company's position.		
	Share Capital Account . . . *Dr.*	60,000	
	To Profit and Loss Account . .		25,000
	,, Realization Account (Loss) .		15,000
	,, Sundry Members' Account . .		20,000
	Balances transferred (outside capital only being relevant).		
	Share Capital Account . . *Dr.*	20,000	
	Debentures Account . . . *Dr.*	50,000	
	Debenture Interest Account . *Dr.*	2,500	
	To Excelsior Ltd.		72,500
	Set-off and cancellation of amounts held by purchasing company.		
	Shares in Excelsior Ltd. . . . *Dr.*	20,000	
	To Excelsior Ltd.		20,000
	Receipt of 20,000 shares at par.		

JOURNAL—(*contd.*)

		£	£
	Sundry Members' Account . . *Dr.*	20,000	
	To Shares in Excelsior Ltd. . .		20,000
	Distribution of 20,000 shares of £1 each in Excelsior Ltd. at par to outside holders of 60,000 shares in Phoenix Ltd. on the basis of the shares in Excelsior Ltd. being worth 30s each		

EXCELSIOR LTD.

JOURNAL

		£	£
Jan. 1	Sundries . . . . . *Dr*		
	Land and Buildings . . .	25,000	
	Plant and Machinery . . .	45,000	
	Stocks and Work-in-Progress . .	23,500	
	Sundry Debtors	24,900	
	Cash	2,600	
	To Sundry Creditors . . .		28,500
	,, Phoenix Ltd.		92,500
	Assets and Liabilities taken over per arrangement sanctioned 16th February.		
	Phoenix Ltd. . . . . . *Dr.*	92,500	
	To Share Capital Account . .		20,000
	,, Shares in Phoenix Ltd. Account		14,500
	,, Debentures in Phoenix Ltd. Account		50,000
	,, Interest Receivable Account .		2,500
	,, Capital Reserve		5,500
	Discharge of consideration and transfer to Capital Reserve of nominal profit on the transaction.		

Notes. (1) It is assumed that Excelsior Ltd., had taken credit for accrued interest on debentures, i.e. it appeared as a debit balance in their books.

(2) It would appear that no notice has been taken of the premium on the shares issued to the outside shareholders of Phoenix Ltd., since the question states that the shares were issued at par.

(8) *AB Ltd. are manufacturers supplying the trade only. The directors decide to change the company's trading policy and to sell direct to consumers through the medium of retail shops.*

In order to effect this change, it is arranged provisionally that the company shall amalgamate with CD Ltd. who own a number of retail shops.

It is proposed that a new company be formed to take over the businesses of the two companies, this company to be registered with an Authorized Capital of £300,000 divided into 200,000 Ordinary Shares of £1 each and 100,000 6 per cent Preference Shares of £1 each.

The following are the Balance Sheets of the respective companies on 31st December—

AB LTD.

Liabilities	£	*Assets*	£
Authorized Capital— 200,000 *Ord. Shares of £1 each*	200,000	*Freehold Premises*	110,000
		Plant and Machinery	26,725
Issued Capital— 180,000 *Shares* 15*s. paid*	135,000	*Stock*	10,400
Premiums on Shares	16,875	*Debtors*	4,190
Reserve	3,000	*Advertising Suspense Account*	1,750
Creditors	1,060	*Cash*	4,655
Profit and Loss Account Balance	1,785		
	£157,720		£157,720

CD LTD.

Liabilities	£	*Assets*	£
Authorized Capital— 100,000 *Ord. Shares of £1 each*	100,000	*Goodwill*	12,500
		Freehold Shops	64,100
Issued Capital— 100,000 *Shares of £1 each fully paid*	100,000	*Fixtures and Fittings*	12,050
5% *Debentures*	10,000	*Stock*	25,400
do. *Interest accrued*	500	*Debtors*	1,325
Creditors	5,240	*Cash*	425
Profit and Loss Account, Balance	60		
	£115,800		£115,800

It is proposed that the amalgamation be on the following basis—

(*a*) *The new company to take over the Assets and Liabilities of the two companies at book values, with the exception of the advertising suspense account standing in the books of AB Ltd. which was to be written off against the Reserve Account of that company.*

(*b*) *The shareholders of AB Ltd. to receive two ordinary shares and one preference share, fully paid, for every three shares held.*

(*c*) *The shareholders of CD Ltd. to receive two ordinary shares and two preference shares, fully paid, for every five shares held.*

(*d*) *The new company to discharge the debentures and accrued interest in CD Ltd. by the issue of* 7½ *per cent debentures at* 105.

(*e*) *The expenses of amalgamation, estimated at* £4,500, *to be paid by the new company and to be charged as far as possible against the Profit and Loss Account and Reserve Account balances taken over.*

You are asked by the directors to criticize the proposals as set out.

(i) *Submit your reply, in the form of a concise report to the directors, pointing out what further information, if any, you would require before you could complete your criticisms;*

(ii) *draft the journal entries necessary to give effect to the proposals in the books of the new company; and*

(iii) *give its initial Balance Sheet.*

(i) *27th November*, 19 . . .

The Directors,
AB Ltd.

Dear Sirs,

We have considered the provisional arrangements which have been made for the amalgamation of your company with CD Ltd.

In order that we may be able to advise you fully on the scheme, it will be necessary to obtain the following information in respect of both CD Ltd. and AB Ltd.—

(*a*) Detailed Profit and Loss Accounts, for six or seven years, if possible, so that the average maintainable profits of the two companies can be computed.

(*b*) The basis of valuation of fixed assets adopted by each company for Balance Sheet purposes and whether it is proposed to instruct a valuer to make a valuation of the fixed assets on a "going concern" basis.

(*c*) The depreciation written off Plant and Machinery and Fixtures and Fittings and in particular whether adequate provision has been made for obsolescence.

(*d*) Whether the stock of each company has been valued on the same basis and in particular whether adequate deductions have been made for obsolete, old and damaged goods.

(*e*) The nature of the trading operations of CD Ltd. and in particular the proportion of the turnover which is applicable to goods manufactured by AB Ltd. and the proportion applicable to supplies from other sources.

(*f*) The individual trading results of each of CD Ltd.'s shops and whether it is proposed to close any of them.

(*g*) Whether it is anticipated that the merger will increase or reduce AB Ltd.'s turnover. If an increase is expected, whether the additional output can be manufactured by the existing plant. Where a reduction is expected, the extent to which it will affect the costs of production through the allocation of overhead expenses over a smaller output.

(*h*) Whether either company has incurred any contingent liabilities, e.g. pending litigation and forward contracts, and if so particulars thereof.

(*i*) Whether it is proposed to issue any shares of the new company to the public, e.g. by means of an offer for sale or Stock Exchange introduction.

(*j*) Whether any charge is created by the debentures of CD Ltd. and, if so, particulars thereof.

(ii) Subject to the answers received to the above questions

the proposals for amalgamation may be criticized on the following grounds—

(*a*) The proposed purchase consideration for the respective undertakings is as follows—

	AB Ltd.		CD Ltd.
	£		£
6 per cent Preference Shares of £1 each fully paid	60,000		40,000
Ordinary Shares of £1 each fully paid	120,000		40,000
	180,000		80,000
The net assets to be taken over (exclusive of Goodwill) at Balance Sheet values are . . .	154,910		87,560
Goodwill .	£25,090	Deficiency	£7,560

Without information as to the maintainable profits of AB Ltd. it is impossible for us to form an opinion as to the justification for the price which it is proposed that the new company shall pay for the Goodwill of AB Ltd. In the case of CD Ltd. the excess of the Balance Sheet values of the assets over the proposed purchase consideration may be due to the over-valuation of the assets, or to the fact that the maintainable profits of that company are insufficient to provide an adequate return upon the capital employed, so that the deficiency is in the nature of a "badwill."

(*b*) The proposed allocation of the purchase consideration will result in the first £6,000 of the profits of the new company being divided between the shareholders of AB Ltd. and CD Ltd. in the proportions of 6 : 4 and the balance of the profits in the proportions of 12 : 4. It is impossible, in the absence of the information referred to above, to comment on the equity of this distribution. Prima facie, however, it is not apparent, in view of the fact that the whole of the capital of both companies is in the form of Ordinary Shares, why the shareholders of one of the companies should receive a larger proportion of their capital in the form of fixed dividend bearing Preference Shares than the shareholders of the other company.

(*c*) With regard to the debentures, if these are secured by a charge on the assets of CD Ltd. and a similar charge is to be given on the assets of the new company, the security behind the debentures will be increased. This additional security, and the reduction in interest rates which has taken place in recent years, should furnish grounds for replacement of the debentures on less onerous terms. The proposed

increase in the rate of interest payable on the debentures would not appear to be justified by the circumstances, and represents unsound finance.

We shall be pleased to furnish you with a more precise criticism of the proposed terms of amalgamation on receipt of the information referred to above.

Yours faithfully,
Chartered Accountants.

(ii) NEW COMPANY'S JOURNAL

		£	£
Jan. 1	Sundries . . . . . . *Dr.*		
	To Sundries:		
	Freehold Premises	110,000	
	Plant and Machinery	26,725	
	Stock	10,490	
	Debtors	4,190	
	Cash	4,655	
	Goodwill	25,090	
	Creditors		1,060
	Liquidator of AB Ltd.		180,000
	Being acquisition of the undertaking of AB Ltd. as at this date per contract dated........		
	Liquidator of AB Ltd. . . . *Dr.*	180,000	
	To Sundries:		
	6 per cent Preference Share Capital Account		60,000
	Ordinary Share Capital Account		120,000
	Being discharge of the purchase consideration for the undertaking of AB Ltd. by the issue to the shareholders of that company of— 60,000 6% Preference Shares of £1 each fully paid. 120,000 Ordinary Shares of £1 each fully paid.		
	Sundries . . . . . . *Dr.*		
	To Sundries:		
	Freehold Shops	64,100	
	Fixtures and Fittings	12,050	
	Stock	25,400	
	Debtors	1,325	
	Cash	425	
	Capital Reserve Account		7,560
	5% Debenture-holders in CD Ltd. .		10,500
	Creditors		5,240
	Liquidator of CD Ltd.		80,000
	Being acquisition of the undertaking of CD Ltd. as at this date per contract dated........		

NEW COMPANY'S JOURNAL—(*contd.*)

	£	£
Liquidator of CD Ltd. . . . *Dr.*	80,000	
To Sundries:		
6% Preference Share Capital Account		40,000
Ordinary Share Capital Account		40,000
Being discharge of the purchase consideration for the undertaking of CD Ltd. by the issue to the shareholders of that company of— 40,000 6% Preference Shares of £1 each fully paid 40,000 Ordinary Shares of £1 each fully paid.		
5% Debenture-holders of CD Ltd. *Dr.*	10,500	
To Sundries:		
7½ % Debentures		10,000
Premium on Debentures . .		500
Being discharge of £10,000 5% Debentures with £500 accrued interest in CD Ltd. by the issue of £10,000 7½% Debentures at 105		

(iii) INITIAL BALANCE SHEET OF THE NEW COMPANY
As at 1st January

Capital and Liabilities	£	£	*Assets*	£	£
Share Capital—			Goodwill (at Cost) .		25,090
Authorized:			Freehold Premises (at Cost) . .	174,100	
100,000 6% Pref. Shares of £1 each .	100,000		Plant and Machinery (at Cost)	26,725	
200,000 Ord. Shares of £1 each . . .	200,000		Fixtures and Fittings (at Cost) . . .	12,050	
	£300,000				212,875
Issued:					237,965
100,000 6% Pref. Shares of £1 each fully paid .	100,000		*Deduct* Capital Reserve Account . . .		7,560
160,000 Ord. Shares of £1 each fully paid .	160,000				230,405
		260,000	Stock	35,800	
7½% Debentures (secured on the property of the Company) . . .	10,000		Debtors	5,515	
Premium on Debentures .	500		Cash	580	
		10,500			41,895
			Preliminary Expenses .		4,500
		270,500			
Creditors		6,300			
	£	276,800		£	276,800

Notes. (1) It will be necessary to transfer the balance on Capital Reserve Account appropriately to the asset accounts

which are overstated (and/or to the liability accounts which are understated).

(2) The Preliminary Expenses have been left in the Balance Sheet. If the suggestion made in Part (e) above is adopted, the Goodwill valuation will be increased by £3,035 and the Preliminary Expenses will be shown in the Balance Sheet at £1,465.

(5) *A Ltd. was absorbed by B Ltd. on the following terms—*

(1) *Each £100 of A Ltd. Debentures to be discharged by the issue of £90 of 5 per cent Debenture Stock in B Ltd.*

(2) *B Ltd. to assume all the other liabilities of A Ltd.*

(3) *Three shares in A Ltd. to be exchanged for two fully-paid £1 shares in B Ltd., at an agreed value of 22s. for each share in B Ltd.*

(4) *B Ltd. to pay the liquidator cash to enable him to repay at par fractions of shares, which amounted in all to 1,500 shares.*

(5) *The Liquidator to retain £1,000 out of the assets of A Ltd. to meet the costs of the liquidation.*

The abridged Balance Sheet of A Ltd. on the day of the transfer was as follows—

	£		£
Share Capital—		*Freehold and Leasehold Properties*	540,000
900,000 Shares of £1 each, fully paid	900,000	*Plant and Machinery*	400,000
4½% Debentures	250,000	*Shares in Subsidiary Companies*	160,000
Mortgage on Leasehold Properties	50,000	*Leasehold Redemption Fund—*	
Sundry Creditors	25,000	*Endowment Policies at surrender value*	15,000
Leasehold Redemption Fund	15,000	*Pension Fund Investments*	60,000
Reserve for Losses anticipated on guarantees given on behalf of Subsidiary Companies	30,000	*Stock and Debtors*	150,000
Pensions Fund	60,000	*Balance at Bankers*	50,000
Dividends unclaimed	5,000		
Profit and Loss Account	40,000		
	£1,375,000		£1,375,000

A Ltd. had contingent liabilities in respect of—

(a) Guarantees, to the extent of £75,000, in respect of amounts due to Bankers by Subsidiary Companies.

(b) Bills discounted totalling £10,000, one of which, for £3,000, fell due ten days after the transfer and was dishonoured.

Set out Journal entries to close the books of A Ltd.

JOURNAL

		£	£
Realization Account . . *Dr.*		1,359,000	
Leasehold Redemption Fund . *Dr.*		15,000	
To Freehold and Leasehold Properties			540,000
" Plant and Machinery . .			400,000
" Shares in Subsidiary Companies			160,000
" Endowment Policies . .			15,000
" Pension Fund Investments .			60,000
" Stock and Debtors . . .			150,000
" Cash			49,000
Sundry assets taken over by B Ltd.			
Sundries— *Dr.*			
Mortgage		50,000	
Sundry Creditors		25,000	
Pensions Fund		60,000	
Reserve for Losses on Guarantees .		30,000	
Dividends unclaimed . . .		5,000	
To Realization Account . .			170,000
Sundry liabilities taken over by B Ltd.			
Sundries— *Dr.*			
Share Capital		900,000	
Profit and Loss Account . .		40,000	
To Sundry Members . . .			940,000
Balances transferred.			
B Ltd. . . . . *Dr.*		884,850	
To Realization Account . .			884,850
Purchase consideration, viz.—			
5% Debentures . . .	£225,000		
598,500 Shares at 22s. per share . . .	658,350		
~~Cash for 1,500 Shares at par~~	1,500		
	£884,850		

JOURNAL—(*contd.*)

		£	£
	Realization Account . . . *Dr.*	1,000	
	To Cash		1,000
	Payment of Costs.		
	Debentures . . . . . *Dr.*	25,000	
	To Realization Account . .		25,000
	Amount agreed upon as discount in exchange.		
	Debentures in B Ltd. . . . *Dr.*	225,000	
	Shares in B Ltd. . . . . *Dr.*	658,350	
	Cash . . . . *Dr.*	1,500	
	To B Ltd.		884,850
	Discharge of consideration.		
	Sundry Members . . . . *Dr.*	280,150	
	To Realization Account . .		280,150
	Loss on realization.		
	Sundry Members . . . . *Dr.*	659,850	
	To Shares in B Ltd. . . .		658,350
	,, Cash		1,500
	Distribution among members.		
	Debentures . . . . . *Dr.*	225,000	
	To Debentures in B Ltd. . .		225,000
	Discharge as agreed by exchange of new debentures for present holdings.		

Notes. (1) It is assumed—

(*a*) That the amount paid to the liquidator by B Ltd. to enable him to repay fractions of shares at par is in respect of 1,500 of the shares in B Ltd. forming part of the consideration.

(*b*) That the reserve for losses and guarantees is included in the "other liabilities" assumed by B Ltd.

(*c*) That the liability for unclaimed dividends is included in the liabilities assumed by B Ltd. under the contract.

(*d*) That the ~~Pension Fund belongs to the employees, and is included in the liabilities assumed by B Ltd.~~

(2) The liability on bills discounted is also included in the liabilities taken over and will be met by B Ltd. This does not at this date affect the books of A Ltd.

(10) *The Summarized Balance Sheets of two companies on 28th February were as follows—*

	Buyers Ltd.	*Sellers Ltd.*
Share Capital Authorized, shares of £1 each	£ 125,000	£ 100,000
Share Capital Issued, fully-paid shares	100,000	82,500
Trade Liabilities	13,000	30,000
Profit and Loss Account . . .	12,000	—
	£125,000	£112,500
Fixed Assets at Cost	80,000	30,000
Floating Assets	45,000	40,000
Goodwill at Cost	—	20,000
Profit and Loss Account . . .	—	22,500
	£125,000	£112,500

On 22nd March the Directors of Buyers Ltd. resolved to take over the business of Sellers Ltd. as from 1st March. The Vendor's shareholders had agreed to accept shares in the purchasing company, the agreed basis being that such shares were worth 27s. 6d. each and that the shares of Sellers Ltd. were worth 10s. each on 28th February. The purchasing Company took over the fixed assets of Sellers Ltd. together with the floating assets not required to pay the liabilities.

The necessary formalities were carried out and the shares were issued by Buyers Ltd. on 10th April.

Give detailed Journal entries recording the transaction in the books of the purchasing company and draw up a Summary Balance Sheet to show the effect of the merger on the Balance Sheet of Buyers Ltd.

JOURNAL

		£	£
Apr. 10	Sundries . . . . *Dr.*		
	To Sellers Ltd. Account . . .		41,250
	Goodwill Account	1,250	
	Fixed Assets Accounts . . .	30,000	
	Floating Assets Accounts . . .	10,000	
	Sundry Assets as at 1st March, acquired for a consideration of £41,250 per agreement of dated 10th April . .	£41,250	£41,250

JOURNAL—(*contd.*)

		£	£
	Sellers Ltd. Account . . . . *Dr.*	41,250	
	To Share Capital Account . .		30,000
	,, Premium on Shares Account .		11,250
	Allotment of 30,000 shares of £1 each at 27s. 6d. per share per agreement of this day.		

BUYERS LTD.

SUMMARIZED BALANCE SHEET

	£		£
Share Capital:		Goodwill at Cost . . .	1,250
Authorized: say 130,000 shares		Fixed Assets at Cost . .	110,000
of £1 each	130,000	Floating Assets . . .	54,945
		Expenses of Increase of Capital,	
Issued:		say	55
130,000 shares of £1 each fully			
paid	130,000		
Premium on Shares . . .	11,250		
Trade Liabilities . . .	13,000		
Profit and Loss Account . .	12,000		
£	166,250	£	166,250

Notes. (1) The issue of the new shares increases the capital of Buyers Ltd., by £5,000 above that authorized. An assumed figure of the cost of such increase has been entered in the Balance Sheet.

(2) Goodwill would probably be written off to premium on shares account.

(11) *Peters and James Ltd. decided to reconstruct and consequently went into Voluntary Liquidation. Their Balance Sheet was as follows—*

Liabilities		£	*Assets*		£
Share Capital (Authorized and Issued)—			*Land and Buildings* . .		31,800
40,000 7% *Pref. Shares of £1 each fully paid*	£40,000		*Plant and Machinery* .		16,500
60,000 *Ord. Shares of £1 each fully paid* . .	60,000		*Motor Lorries* . . .		620
		100,000	*Stock-on-Hand* . . .		8,350
Profit prior to Incorporation		1,210	*Trade Debtors* . . .	£13,400	
Loans		500	*Less Discount* . .	300	
Trade Creditors . . .	£8,610				13,100
Bills Payable . . .	420		*Cash in hand* . . .		40
		9,030	*Profit and Loss Account* .		41,270
Bank Overdraft . .		940			
(Note.—*There is a contingent liability in respect of a claim for Royalties amounting to £1,450.*)					
		£111,680			£111,680

It was arranged that a new company—Peters & James (New) Ltd.—should be formed to acquire the undermentioned assets at the values stated: Land and Buildings £20,000, *Plant and Machinery,* £12,000, *Motor Lorries* £400, *Stock* £7,600. *The total of* £40,000 *payable was satisfied by the allotment of* 20,000 6 *per cent Preference Shares of* £1 *each, fully paid and* 30,000 *Ordinary Shares of* £1 *each credited with* 13*s*. 4*d*. *paid.*

The new company also satisfied the contingent liability in respect of a claim for royalties by allotting to the claimant 500 *Ordinary Shares, fully paid.*

The Preference Shareholders in the old company accepted the Preference Shares in the new company in satisfaction and the Ordinary Shareholders took the partly-paid Ordinary Shares.

The Book Debts realized £12,725 *and the amount of the Trade Creditors proved to be* £8,834. *The liabilities were discharged and the costs of the Winding-up were* £1,071.

Preliminary Expenses were paid by the new company.

(1) *Close the books of the old company, showing the necessary Cash Book entries and Ledger Accounts.*

(2) *Give the Journal entries recording the transactions of the new company.*

OLD COMPANY'S BOOKS

PROFIT AND LOSS ON REALIZATION ACCOUNT

	£		£
To Land and Buildings Account	11,800	By Peters and James (New) Ltd. Account	
„ Plant and Machinery Account	4,500	„ Agreed Amount in satisfaction of contingent liability	500
„ Motor Lorries Account	220	„ Sundry Members' Account—Loss on Realization	18,940
„ Stock	750		
„ Contingent Liability	500		
„ Reserve for Discount on Debtors Account	375		
„ Cash—Costs of Winding-up	1,071		
„ Trade Creditors—Additional Liability	224		
	£19,440		£19,440

Trade Debtors' Account

	£		£
To Balance b/f	13,400	By Cash	12,725
		" Discount Reserve Account, Discount allowed	675
	£13,400		£13,400

Reserve for Discount Account

	£		£
To Trade Debtors Account	675	By Balance b/f	300
		" Realization Account	375
	£675		£675

Sundry Members' Account

	£		£
To Profit and Loss Account	41,270	By Preference Share Capital Account	40,000
" Profit and Loss on Realization Account—Loss	18,940	" Ordinary Share Capital Account	60,000
" Cash	1,000	" Profit prior to Incorporation Account	1,210
" Peters & James (New) Ltd. Account:			
20,000 6% Pref. Shares of £1 each, fully paid	20,000		
30,000 Ord. Shares of £1 each 13s 4d. paid	20,000		
£	101,210	£	101,210

Contingent Liability Account

	£		£
To Peters & James (New) Ltd. Account 500 Ord. Shares of £1 each fully paid	500	By Profit and Loss on Realization Account— Agreed amount of liability.	500

Sundry Creditors' Account

	£		£
To Cash	9,754	By Loans Accounts	500
		" Trade Creditors Accounts	8,610
		" Bills Payable Account	420
		" Profit and Loss on Realization Account— Additional liability	224
	£9,754		£9,754

Peters & James (New), Ltd. Account

	£		£
To Sundry Assets Accounts—agreed purchase price of assets, viz.— Land and Buildings £20,000 Plant and Machinery 12,000 Motor Lorries . 400 Stock . . . 7,600	40,000	By Sundry Members Account, Shares in Peters & James (New) Ltd.— 20,000 6% Pref. Shares of £1 each, fully paid . .	20,000
		30,000 Ord. Shares of £1 each 13s. 4d. paid . .	20,000
,, Profit and Loss on Realization Account, re satisfaction of Contingent liability . .	500	,, Contingent Liability Account 500 Ord. Shares of £1 each fully paid	500
	£40,500		£40,500

Cash Book

	£		£
To Balance b/f	40	By Costs of Winding-up . .	1,071
,, Trade Debtors' Accounts	12,725	,, Trade Creditors' Accounts .	8,834
		,, Bills Payable Account . .	420
		,, Bank Overdraft . . .	940
		,, Loans Account . .	500
		,, Sundry Members' Account—Ordinary shareholders 4d. per share	1,000
	£12,765		£12,765

Notes. (1) In view of the fact that the Preference Shareholders have accepted the shares in the new company in satisfaction, it has been assumed that the £1,000 cash balance belongs to the Ordinary Shareholders.

(2) It is assumed that the difference on realization of the debtors is all discount, and includes no bad debts.

NEW COMPANY'S BOOKS

Journal

		£	£
	Sundries . . . . . . *Dr.*		
	To Peters & James Ltd.		40,500
	Goodwill Account	500	
	Land and Buildings Account . .	20,000	
	Plant and Machinery Account . .	12,000	
	Motor Lorries	400	
	Stock	7,600	
	Assets acquired per agreement of this date; £500 charged to Goodwill being amount agreed in satisfaction of claim for royalties on vendors.		

JOURNAL—(*contd.*)

		£	£
	Peters & James Ltd. . . . *Dr.*	40,500	
	To Preference Share Capital Account		20,000
	,, Ordinary Share Capital Account .		20,500
	Allotment per minute of this day of 20,000 6% Preference Shares of £1 each, fully paid; 30,000 Ordinary Shares of £1 each 13s. 4d. paid; and 500 Ordinary Shares of £1 each, fully paid, in satisfaction of purchase consideration.		

Note. The preliminary expenses, when paid, would be charged to an account of that name.

(12) *It is proposed to form a company to acquire a manufacturing business at present carried on by a private limited company and to raise money for this purpose by a public issue of shares and debentures.*

It is intended that only the fixed assets of the existing company should be taken over, the purchase price of which is to be £150,000 *and that the new company should repay an existing bank overdraft of* £16,000.

In satisfaction of the purchase consideration, the vendors are to be paid £80,000 *in cash and to be allotted* 20,000 £1 *Ordinary Shares, fully paid, and* 50,000 7 *per cent Cumulative Preference Shares of* £1 *each, fully paid.*

The assets to be acquired are valued as follows—

	£
Freehold Land and Buildings (Factory)	60,000
Shop Premises—Freehold and Leasehold, including Fixtures and Furniture	30,000
Plant, Machinery, and Loose Tools	25,000
Motor Cars and Vans	6,000

Preliminary Expenses in connexion with the formation of the new company are estimated at £10,000.

It is proposed to offer at par for public subscription 20,000 Ordinary Shares of £1 each, 50,000 7 per cent Cumulative Preference Shares of £1 each, and £80,000 in 6 per cent Debentures secured on the Freehold Land and Buildings.

The distributable profits, arrived at after charging all expenses applicable to the year but before any transfers to reserve, are stated to have been sufficient, in the year to 31st December, 1936, to pay the Debenture Interest, the dividend on the Preference Shares, and a dividend of 15 per cent on the Ordinary Shares.

It is ascertained that in earlier years the profits, similarly computed, were as follows—

		£
Year to 31st December	1930	4,200
Do.	1931	10,600
Do.	1932	15,700
Do.	1933	13,800
Do.	1934	7,600
Do.	1935	18,150

You are asked (i) *to criticize the proposed capital arrangements from the point of view of the company and of the anticipated investor, and* (ii) *to draft the Balance Sheet as it would appear after giving effect to the above information, assuming that all the capital issued for public subscription was fully subscribed.*

(i) It would appear that both from the point of view of the company and of an anticipated investor the proposed capital arrangements are open to serious criticism.

The total amount of the purchase consideration to be paid by the company is £166,000, whereas the value of the tangible assets to be taken over is only £121,000, leaving £45,000 attributable to goodwill. It is considered that this valuation is

grossly excessive. Although the profits for each of the years 1935 and 1936 have been sufficient to provide a substantial return upon the ordinary shares, over the period of seven years the profits have fluctuated greatly, the average profits before making any transfer to reserve or providing for the debenture interest or preference dividend being only £12,550. Since the amount required to pay the debenture interest and preference dividend is £11,800, there would remain a balance of only £750 wherewith to maintain necessary reserves and pay dividends on the ordinary shares.

Moreover, if the profits given in the question have been arrived at before providing for depreciation on the fixed assets, the position would be still more unsatisfactory, and it would probably be found that after adequate provision for depreciation of fixed assets had been made the profits would be insufficient even to pay the debenture interest.

It should further be observed that, since the vendors are to receive, as part of the purchase consideration, one-half of the ordinary shares issued by the company, they would, in fact, be retaining one-half of the goodwill, and they should not also receive payment, out of moneys contributed by other shareholders, for the proportion of the goodwill attaching to the ordinary shares which are allotted to them.

Assuming, however, that depreciation of the fixed assets has been taken into account before arriving at the profits, there would still appear to be no super-profits, and, therefore, no goodwill, and the company is making a very bad bargain in paying £45,000 for this asset. Even though the

payment for goodwill were eliminated altogether from the purchase price and the cash consideration reduced accordingly so that the debenture issue could be reduced to £35,000, there would still be left only £3,450 profit, before maintaining reserves, available for the ordinary shareholders, and if adequate transfers to reserve are to be made, this would still mean that there would be practically no return upon the ordinary shares.

A further criticism is that whereas no less than £180,000 is represented by fixed interest-bearing debentures and preference shares, only £40,000 is represented by ordinary shares—an undue proportion of priority capital. The amount required to pay the fixed interest and dividends is much too great a burden upon the company by comparison with the amount of capital invested. A larger proportion of the capital should be represented by ordinary shares.

Again, the rates payable on the debentures and preference shares are very high by comparison with current standards, although probably not incommensurate with the risk attaching to the investment. In this connexion it is noted that the debentures are not fully secured, even on the basis of the book value of the freehold land and buildings, on which they are charged. An even greater discrepancy would probably be disclosed should the security have to be realized, since the buildings, being a factory, are probably of a specialized character, and would almost inevitably have to be sold at a sacrifice. Without a floating charge over the other assets, the debentures are not attractive, although the interest appears to be covered; whilst

in the case of the preference shares the rate of 7 per cent may not represent an adequate yield, having regard to the speculative nature of the investment.

ii) BALANCE SHEET

After giving effect to the scheme

	£	£		£
Capital— Authorized: Issued:			Goodwill, at cost	45,000
40,000 Ord. Shares of £1 each, fully paid	40,000		Freehold Land and Building (Factory), at cost	60,000
100,000 7% Cum. Pref. Shares of £1 each, fully paid	100,000		Shop Premises—Freehold and Leasehold, including Fixtures and Furniture, at cost	30,000
		140,000	Plant, Machinery and Loose Tools, at cost	25,000
6% Mortgage Debentures		80,000	Motor Cars and Vans, at cost	6,000
			Preliminary Expenses	10,000
			Cash	44,000
	£	220,000	£	220,000

(13) *A Co. Ltd. went into liquidation and its whole undertaking was sold to B Co. Ltd., the terms agreed to by the parties being—*

(*a*) *The Discharge of the Debentures outstanding by the issue of £95 of 5 per cent Debenture Stock in B Co. Ltd. for each £100 of A Co. Ltd. Debentures;*

(*b*) *the assumption by the transferee of all other liabilities of the transferor; and*

(*c*) *the exchange of five £1 fully-paid shares in B Co. Ltd., at an agreed value of 25s. a share, for every eight shares in A Co. Ltd.*

B Co. Ltd. also undertook to pay the liquidator of A Co. Ltd. a sum of money, on the basis of 20s. per share, to enable him to deal with fractions of shares; the number of shares represented by the addition of the fractions was 940.

The abridged Balance Sheet of A Co. Ltd. on the day of the transfer was as follows—

	£		£
Share Capital—		*Freehold Properties* .	600,000
800,000 *Shares of* £1 *each, fully paid* .	800,000	*Plant and Machinery* .	200,000
$5\frac{1}{2}$% *Debentures* . .	100,000	*Investments on Accident Compensation Fund* .	5,000
Creditors	15,000	*Stock and Debtors* .	150,000
Employees' Profit Sharing Fund . .	25,000	*Balance at Bankers* .	10,000
Fatal Accident Compensation Fund . .	5,000		
Profit and Loss Account	20,000		
Note.—In settlement of a dispute the Company has issued certain Certificates for £12,500, undertaking to pay that sum to the Holders out of Profits if and when earned.			
Bills discounted totalling £3,000 have not matured due.			
	£965,000		£965,000

Five days after the day of the transfer one of the discounted Bills, for £1,000, fell due and was dishonoured.

Show Journal Entries to close the books of A Co. Ltd. Ignore the costs of the liquidation.

JOURNAL

		£	£
	Realization Account . . . . *Dr.*	965,000	
	To Freehold Properties . . .		600,000
	,, Plant and Machinery . . .		200,000
	,, Investments		5,000
	,, Stock and Debtors . . .		150,000
	,, Balance at Bankers . . .		10,000
	Assets transferred to B Co. Ltd. per agreement of this day.		
	Creditors . . . . . . *Dr.*	15,000	
	Employees' Profit Sharing Fund . .	25,000	
	To Realization Account . . .		40,000
	Liabilities transferred to B Co. Ltd. per agreement of this day.		

JOURNAL—(*contd.*)

	£	£
B Company Ltd. . . . . . *Dr.*	719,765	
To Realization Account . . .		719,765
Purchase consideration per agreement of this day.		
Debenture Account . . . . *Dr.*	100,000	
To Realization Account . . .		5,000
„ Sundry Debenture-holders . .		95,000
Transfer of Debentures to be discharged at 95% by B Co.		
Share Capital Account . . . . *Dr.*	800,000	
Fatal Accident Compensation Fund .	5,000	
Profit and Loss Account . . .	20,000	
To Sundry Members Account . .		825,000
Sundry Balances transferred.		
Sundry Members Account . . . *Dr.*	200,235	
To Realization Account . . .		200,235
Loss on Realization transferred.		
Sundry Debenture-holders Account *Dr.*	95,000	
Sundry Members Account . . .	624,765	
To B Co. Ltd.		719,765
Satisfaction of purchase consideration by— £		
Allotment of £95,000 Debentures in B Co. Ltd. to Debenture-holders of A Co. Ltd. 95,000		
Allotment of five shares of £1 each in B Co. Ltd. at 25s. per share for every eight shares in A Co. Ltd., i.e. 499,060 shares in B Co. Ltd. for 798,496 shares in A Co. Ltd. 623,825		
Cash in respect of 940 shares in B Co. Ltd. for 1,504 shares in A Co. Ltd., being five shares in B Co. Ltd. at 20s. per share for every eight shares in A Co. Ltd. . 940		
£719,765		

Notes. (1) The B Company Ltd., has taken over the whole of the liabilities of the A Company, Ltd., and the Liquidator of the A Company will therefore notify the B Company of the

dishonoured bill and the liability thereon, which the B Company will meet.

(2) The liability to the Certificate holders ~~would appear to be~~ discharged, unless the certificates give ~~any right to damages,~~ ~~which would be met by the B~~ Company.

RELIEF FROM STAMP DUTY ON AMALGAMATIONS

Under Section 55, Finance Act, 1927, where a new company is formed, or the capital of an existing company is increased, for the purpose of—

(1) Purchasing all or part of the undertaking of another company, and at least 90 per cent of the purchase consideration is to be paid in shares in the purchasing company; or

(2) Acquiring at least 90 per cent of the issued capital of another company;

for the purpose of calculating the 10s. per cent capital duty on the nominal capital of the new company or on the increase in nominal capital of the purchasing company, that capital or increase in capital is to be deemed to be reduced by—

(*a*) An amount equal to the share capital of the vending or subsidiary company; or

(*b*) Where only part of the undertaking of the vending company is acquired, by that proportion of the share capital of the vending company which the portion of the undertaking acquired bears to the whole undertaking; or

(*c*) The amount to be credited as paid up on the shares to be issued as such consideration, if this is less than the amount computed as in (*a*) or (*b*) above.

Example. *The C Company, with a nominal capital of £100,000, of which £90,000 is issued and fully paid,*

increases its nominal capital by £50,000 for the purpose of acquiring one-half of the undertaking of Y Ltd., whose nominal capital is £50,000. The purchase consideration is £30,000, payable as to £3,000 in cash and £27,000 in £1 shares in the X Company Ltd., credited as 10s. per share paid up.

	£
For the purposes of 10s. per cent Stamp Duty, the increase in the nominal capital of X Ltd. of	50,000
is reduced by (*a*) one-half the nominal capital of Y Ltd. = £25,000; or (*b*) the amount credited as paid up on the shares issued as purchase consideration, viz. 10s. per share on 54,000 shares = £27,000; whichever is less	25,000
10s. per cent Stamp Duty will therefore be payable on	£25,000

No Stamp Duty is chargeable on any contract, transfer, or assignment of the assets or shares to the purchasing company, provided the contract is duly stamped with a "denoting stamp" showing that it is not chargeable with duty; and is executed within twelve months from the date of registration of the new company or increase of capital, as the case may be, or is filed to give effect to an agreement relating to an allotment of shares for consideration other than cash filed with the Registrar of Companies within such period of twelve months.

A company which issues any of its unissued capital for the purpose of an amalgamation or reconstruction is entitled to the above exemption from contract, etc., duty, but no relief from capital duty is available.

Where a business is being taken over from a sole trader or partnership it is a common practice, in order to save stamp duties, for the company not to take over the debtors and creditors, but to

collect the debts and pay the creditors as agent for the vendor. The company's Cash Book must then be provided with an additional column on each side for recording money so received and paid on behalf of the vendor, the totals of such columns being posted periodically to the Vendor's Account, to which the purchasing company will debit its commission, if such has been agreed upon.

It may sometimes happen that, on a private business being converted into a limited company, no entries relating to the transfer are made at the time, but the old firm's books are carried on without a break until the end of the year as if no change had taken place. In such a case, it will be impossible to make the usual opening entries to record the purchase of the business by the company, but adjustments must be made to give effect to the true position of affairs when the time arrives for the next Balance Sheet to be prepared.

Illustration. *The following is the Trial Balance of A Ltd. on 31st December—*

	£	£
A—Capital Account		10,000
Sundry Fixed Assets	4,000	
Debtors	5,000	
Stock	6,000	
Cash	1,000	
Sundry Liabilities		4,000
Profit and Loss Account		2,000
	£16,000	£16,000

It is ascertained that on the preceding 1st March the business had been transferred to a limited company as from 1st January in consideration of £3,000 cash and £12,000 shares, the company taking over all the assets and liabilities at their book value. No entries relating to the transfer had been made in the

books, nor had any entries been made in A's Capital Account since 1st January, except that he had been debited with the £3,000 cash paid to him as part of the purchase consideration.

Since A's Capital Account at the end of the year stands at £10,000, after having been debited with the £3,000 cash forming part of the purchase consideration, his capital at the beginning of the year must have been £13,000, and this represents the amount of the assets, less liabilities, as at 1st January, which were taken over by the company. Had the company opened a new set of books at that date, the opening Journal entries would have been—

	£	£
Sundry Net Assets . . .	13,000	
Goodwill Account . . .	2,000	
To Vendor—A . . .		15,000
Vendor—A	15,000	
To Cash		3,000
,, Share Capital Account .		12,000

Since, however, the company has *not* opened a new set of books, but has continued to operate upon the existing asset and liability accounts, the balance of A's Capital Account at the commencement of the year, £13,000, represents the credit to the Vendor for the net assets taken over from him. A, having already received, and been debited with, £3,000 of the purchase consideration, the only entries now necessary to put the books in order are as follows—

	£	£
Goodwill Account . . *Dr.*	2,000	
To Vendor—A . . .		2,000
Vendor—A . . . *Dr.*	12,000	
To Share Capital Account .		12,000
Purchase of goodwill and discharge of balance of purchase consideration.		

If any adjustment in the book value of the assets is to be made, the amount of such adjustment will be debited or credited to the particular asset accounts, and credited or debited to A's Capital Account. The effect will merely be to increase or decrease the amount to be debited to Goodwill Account.

Where, under the vending agreement, the debtors and creditors of the old firm are not to be taken over by the company, but the debts are to be collected and the liabilities paid by the company on account of the vendors (as explained above), the balance of the Capital Account at the date as from which the business is transferred will *not* represent the net assets taken over by the company under the agreement; but the debtors and creditors at that date must be eliminated therefrom to show the true position. Strictly, therefore, the Vendor's Account should be debited, and the various Debtors' Accounts credited with the amount of the sundry debtors at the date of the transfer of the business; and the sundry Creditors' Accounts debited and the Vendor's Accounts credited with the liabilities not taken over by the company. As and when the amounts are collected from debtors and paid to creditors they would be debited and credited to the Cash Book, and credited and debited respectively to the Vendor's Account, the balance of which would then represent the balance to be accounted for by the company to the vendor, or vice versa.

Where, however, the company has continued to operate upon the old Debtors' and Creditors' Accounts as if no change had taken place, the

actual personal accounts of debtors and creditors will have been credited and debited during the year following the transfer with the cash received and paid by the company respectively, and the above entries will not be practicable. The following entries should, therefore, be made.

Assume that in the above example the debtors and creditors on 1st January were £4,000 and £3,000 respectively, and that these were not to be taken over by the company, but were to be collected and paid by them as agent for the vendors. The old accounts were continued by the company without a break, the debts being collected during the year, subject to discounts of £200, and the creditors paid, subject to discounts of £75.

		£	£
Vendor's Account . . .	*Dr*	4,000	
To Debtors' Suspense Account .			4,000
Creditors' Suspense Account .	*Dr.*	3,000	
To Vendor's Account . . .			3,000
Adjusting debtors and creditors not taken over.			

The effect of the above entry will be to reduce the credit on A's account to £9,000, and thus to increase the price paid for goodwill to £3,000.

At the end of the year, when the amounts collected from debtors and paid to creditors have been ascertained, the following further entries will be necessary—

		£	£
Debtors' Suspense Account .	*Dr.*	4,000	
To Vendor's Account . . .			3,800
,, Discount Allowed Account .			200
Debts collected and discounts allowed on behalf of vendor.			
Vendor's Account . . .	*Dr.*	2,925	
Discount Received Account .	*Dr.*	75	
To Creditors' Suspense Account .			3,000
Liabilities paid and discounts received on behalf of vendor.			

The Vendor's Account will then be closed by the payment to him of £875 cash, being the excess of receipts over payments, and the discounts allowed and received respectively on behalf of the vendor will be eliminated from the company's Discount Accounts. The actual personal accounts of the debtors and creditors will not be affected.

Illustration. *XY, the proprietor of a business, wishing to realize part of his capital, decided to form his business into a limited company as from* 1st *July,* 1935, *and invite his friends to take up shares.*

The company was duly incorporated on 1st *August,* 1935, *on which date* 9,000 *shares of* £1 *each were issued for cash, XY retaining the remaining* 1,000 *shares as part consideration.*

Out of the proceeds of the issue, XY was paid £7,000 *as the balance of the Purchase Price and* £750 *for outlays incurred by him connected with the company's incorporation.*

XY agreed to be manager of the company as from 1st *July,* 1935, *at a salary of* £500 *per annum.*

It was not considered necessary to open up a new set of books and accounts.

The Trial Balance before adjustment, at 30th *June,* 1936, *is as follows—*

	£	£
Capital Account (XY)	1,250	
New Company Account (XY & Co. Ltd.)		9,000
Sales		30,000
Stock Account	22,900	
Wages and Salaries	2,750	
Other Expenses	2,500	
Bad Debts written off during year	175	
Sundry Creditors		3,325
Sundry Debtors	5,000	
Property	6,000	
Cash on hand and in Bank	1,750	
	£42,325	£42,325

XY has not been credited with salary to date nor has he received anything on account. Interest on Purchase Price at 5 per cent, less tax, falls to be credited to him as from 1st July, 1935, to date of settlement. The Stock at 30th June, 1936, is valued at £400.

A re-valuation at 1st July, 1935, showed that the property was worth £6,500, and that £250 of the debts were doubtful or bad. Against the latter it was agreed to reserve £200.

Actually only debts to the value of £100 have proved to be bad, the balance having been collected by the company.

XY's capital at 30th June, 1935, was £6,500.

Prepare Balance Sheet of XY & Co. Ltd., as at 30th June, 1936, with relative Profit and Loss Account to that date, giving effect to the adjustments necessary, but yet unrecorded, on account of the change of ownership. Ignore income-tax.

TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 30TH JUNE, 1936

		£	s.	d.		£	s.	d.
To Stock Account .	£22,900				By Sales	30,000	0	0
Less Stock in Hand	400							
		22,500	0	0				
„ Gross Profit c/d . .		7,500	0	0				
	£	30,000	0	0	£	30,000	0	0
		£	s.	d.		£	s.	d.
To Wages and Salaries . .		2,750	0	0	By Gross Profit b/d . .	7,500	0	0
„ Manager's Salary . .		500	0	0				
„ Other Expenses . .		2,500	0	0				
„ Bad Debts . . .		75	0	0				
„ Net Profit c/d . . .		1,675	0	0				
		£7,500	0	0		£7,500	0	0
		£	s.	d.		£	s.	d.
To Interest on purchase price at 5% on £8,000 Prior to Incorporation, 1 month .		33	6	8	By Net Profit b/d— Prior to Incorporation, 1 month . . .	139	11	8
„ Net Profit prior to Incorporation carried to Capital Reserve		106	5	0	After Incorporation, 11 months . . .	1,535	8	4
Net profit carried forward .		1,535	8	4				
		£1,675	0	0		£1,675	0	0

XY LTD.

Balance Sheet as at 30th June, 1936

Capital and Liabilities	£	s.	d.	Assets	£	s.	d.
Share Capital, authorized, issued and fully paid . .	10,000	0	0	Goodwill . . £1,200 0 0 Less Capital Reserve per contra . 206 5 0	993	15	0
Capital Reserve— Profits prior to Incorporation . £106 5 0 Balance of Bad Debt Reserve on debts taken over . 100 0 0				Property at Cost . . .	6,500	0	0
Deducted contra from Goodwill . . £206 5 0				Stock	400	0	0
Sundry Creditors . . .	3,325	0	0	Debtors	5,000	0	0
XY—Salary and Interest .	533	6	8	Cash on hand and in Bank .	1,750	0	0
Profit and Loss Account . .	1,535	8	4	Preliminary Expenses . .	750	0	0
£	15,393	15	0	£	15,393	15	0

Notes to Solution.—(1) The account of XY will be adjusted as follows—

XY (Vendor)

		£			£
1935 Aug. 1	To Cash . . .	7,750	1935 July 1	By Balance (capital) .	6,500
			1936 June 30	„ Balance c/d (as per Trial Balance) .	1,250
		£7,750			£7,750
		£			£
1936 June 30	To Balance b/d . .	1,250	1936 June 30	By Property Account—Increase in value .	500
	„ Share Capital Account—Shares issued as part consideration .	1,000		„ Preliminary Expenses Account—paid by XY . . .	750
	„ Bad Debt Reserve .	200		„ Balance, being cost of Goodwill debited to Goodwill Account . . .	1,200
		£2,450			£2,450

(2) BAD DEBT RESERVE ACCOUNT

	£		£
To Bad Debts written off . .	100	By XY—Reserve created at acquisition of business . .	200
„ Balance—excessive Reserve transferred to Capital Reserve	100		

By debiting £100 of the Bad Debts written off against the Bad Debts Reserve, only £75 Bad Debts remain to be debited to Profit and Loss Account as representing Bad Debts incurred by the company. The balance of the Bad Debt Reserve taken over from the Vendor may now be treated as a Capital Reserve and deducted from the cost of Goodwill.

(3) In the absence of information as to the incidence of sales, the gross profit, as well as the Profit and Loss Account items, have been apportioned between the periods prior to and after incorporation on a time basis. Strictly the Gross Profit and other items varying with turnover should be apportioned on the basis of turnover.

CHAPTER XIII

HOLDING COMPANIES

A HOLDING company may be defined as one which holds, either directly or through a nominee or nominees, the whole of, or a controlling interest in, the share capital of one or more other companies (termed "subsidiary companies"), for the purpose of consolidating their interests. The subsidiary companies retain their separate legal identities and constitutions, but are effectively controlled in policy and management by the parent company by reason of its possession of the majority of the voting power attaching to the shares. Effect is given to this control by the appointment of nominee directors to the boards of the subsidiary companies, such directors being generally also directors of the parent company.

A subsidiary company is defined by Section 127, Companies Act, 1929, as follows—

(1) Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee, and whether that other company is a company within the meaning of this Act or not (e.g. a foreign company), and—

(*a*) The amount of the shares so held is at the time when the accounts of the holding company are made up more than 50 per cent of the issued share capital of that other company or such as to entitle the company to more than 50 per cent of the voting power in that other company; or

(*b*) The company has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of those provisions) directly or indirectly to appoint the majority of the directors of that other company,

that other company shall be deemed to be a subsidiary company within the meaning of this Act, and the expression "subsidiary company" in this Act means a company in the case of which the conditions of this section are satisfied.

(2) Where a company, the ordinary business of which includes the lending of money, holds shares in another company as security only, no account shall, for the purpose of determining under this section whether that other company is a subsidiary company, be taken of the shares so held.

From the definition, some peculiar results may arise, e.g. if the A Co. has a capital divided into 10,000 £1 Preference Shares (carrying no voting power), 5,000 £1 Ordinary Shares (carrying one vote per share), and 1,000 £1 Deferred Shares (carrying one vote per share and the right to appoint 60 per cent of the directors), and each class of share is acquired by a different company, then there are three holding companies attached to the one "subsidiary company"; since one "holding company" holds over 50 per cent of the issued share capital, the second over 50 per cent of the voting power, and the third the right to appoint the majority of the directors.

From the statutory definition of a subsidiary company it would appear that where the A Company holds a controlling interest in the B Company and the B Company holds a controlling interest in the C Company, the C Company is not a subsidiary of the A Company (even though the A Company *indirectly* has the power to appoint the majority of the directors of the C Company), unless the A Company holds *some* shares (not necessarily more than 50 per cent of the issued share capital) in the C Company.

The advantages of the holding company system are substantially those of amalgamations generally (see Chapter XII). As compared with a complete

amalgamation, there is the added advantage of maintaining the goodwill attaching to each subsidiary, and, as has been said in Chapter XII, secrecy if desired.

There may be other reasons for adopting the holding company system in preference to complete amalgamation, e.g. the subsidiary company may have issued debentures or preference shares on very favourable terms, the benefit of which could not be maintained except by continuing the company and its existing state as a separate entity, or it may have very good contracts the benefit of which might not be assignable, etc.

There are, however, grave disadvantages, the chief of which is the obscuration of results. Huge secret reserves may be built up by the simple expedient of retaining the profits of subsidiary companies in those companies, and taking no credit therefor in the holding company's accounts. Such secret reserves lend themselves most readily to manipulation.

Frequently, too, the holding company acts as "banker" for the whole group of companies, and this may tend to obscure results still further. Inter-company manipulations tend to deceive "outside" members as to the value of their holdings, e.g. goods may pass from one company to another at prices which, while benefiting the group, may seriously prejudice the minority shareholders in individual companies, and inter-company loans without interest or security may have a similar effect. Even creditors may be prejudiced where the funds of one company are used to pay debts of another.

The very fact of the withholding of dividends prejudices minorities. In some cases, this can be most flagrant, the holding company taking credit for the undistributed profits in its accounts and obtaining the use of the money by means of inter-company loans.

Other disadvantages are the dangers of a monopoly contrary to public interest, the risk of the organization becoming unwieldy, the stifling of personal initiative and responsibility owing to excessive centralization, the increased opportunities for fraudulent promotion and management, and the oppression of minorities.

From the legal viewpoint each company of the combine is a separate entity, but from the aspect of the holding company the subsidiary companies are similar to branches of a head office, with the difference that, unless the holding company owns the whole of the share capital in a given subsidiary company, there are others (the shareholders outside the combine) interested in such "branch," the liability to whom must be taken into account.

A company may become a holding company by forming subsidiary companies to which are transferred certain departments or branches of its business, or an existing company may take over sufficient shares to acquire control in other existing companies, which then become subsidiaries; or a new company may be formed to acquire control of existing companies. A holding company may therefore be a trading company as well as a holding company pure and simple, or it may exist as a specialized investment company only for the

purpose of holding the shares in subsidiaries and exercising control over them.

ENTRIES IN BOOKS OF HOLDING COMPANY

In either of the above cases the assets and liabilities of the subsidiary companies are not taken over by the holding company as such, but the holding company merely acquires an "Investment"; the cost of the shares acquired being debited to "Shares in Subsidiary Company" Account; Share Capital Account and/or Debentures Account and/or Cash, as the case may be, being credited with the satisfaction of the purchase price.

Where shares in a subsidiary are paid for by shares in the holding company issued at a premium, the premium should preferably be deducted from the cost of the shares, and only the net amount debited to "Shares in Subsidiary Company" Account, unless such premium is actually represented by tangible assets in the subsidiary, exclusive of Goodwill. It may, however, be credited to Premium on Shares Account.

Where the subsidiary company has undistributed profits standing, on the date on which the holding company acquires the shares in that subsidiary company, to the credit of Reserves or Profit and Loss Account, it must be borne in mind that the holding company has purchased an interest in the net assets representing such profits. If, therefore, a dividend is subsequently paid thereout, the holding company simply receives a portion of the assets for which it paid. The dividend should therefore be credited to the "Shares in Subsidiary Company" Account. The shares

were purchased cum dividend, and the dividend has therefore been paid for in full.

Illustration.

BALANCE SHEET OF SUBSIDIARY COMPANY

	£		£
Capital in £1 shares	100,000	Sundry Assets	170,000
Reserves and Profit and Loss Balances	50,000		
Creditors	20,000		

If the holding company acquired 80 per cent of the shares at their "net asset" value, it paid 80 per cent of £150,000 = £120,000 therefor, i.e. it acquired 80,000 shares at 30s. each, made up of £1 for each share and 10s. for the right to the undistributed profits attributable thereto.

The Investment Account in the holding company's books would read—

SHARES IN SUBSIDIARY COMPANY ACCOUNT

	£		
To Cash, etc., cost of 80,000 shares	120,000		

If immediately thereafter the subsidiary company declared a dividend of 50 per cent, its Balance Sheet, after paying the dividend, would appear as follows—

	£		£
Capital	100,000	Sundry Assets	120,000
Creditors	20,000		

On an asset basis each share is reduced to par.

The holding company would receive £40,000, which it must credit to the Investment Account, as it has, in effect, now received the 10s. which it paid for the dividend on each share. This would reduce the balance of the Investment Account to £80,000, which is obviously the right figure.

Dividends paid out of profits made subsequent to the acquisition, however, are properly credited to Profit and Loss Account, being out of current profits, but it may, in practice, be necessary to make a reserve where the subsidiary company's capital is not being properly maintained out of revenue.

In some cases, a holding company takes credit for its due proportion of all profits made by the subsidiary companies, whether dividends have been declared or not, debiting the subsidiary company therewith. This is referred to again later.

Illustration. *H Ltd. acquired on* 30*th June,* 1936, 50,000 £1 6 *per cent Preference Shares at* 25*s. and* 80,000 *Ordinary* £1 *shares at* 27*s.* 6*d. in S Ltd. The latter had an issued capital of* 100,000 *Preference Shares and* 100,000 *Ordinary Shares.*

On 1*st August,* 1936, *S Ltd. declared and paid a dividend for the half-year to* 30*th June on the preference shares. A further dividend for the half-year to* 31*st December,* 1936, *was declared and paid on* 1*st March,* 1937, *together with an ordinary dividend of* 10 *per cent for the year* 1936. *The profits earned by S Ltd. for* 1936 *amounted to* £14,000, *the balance of the dividends being paid out of profits brought forward from* 1935.

Show the Investment Accounts in H Ltd.'s books, ignoring income-tax.

50,000 PREFERENCE SHARES IN S LTD. ACCOUNT

		£			£
1936 June 30	To Cash, 50,000 shares @ 25s.	62,500	1936 Aug. 1	By Dividend for half-year to 30th June, 1936	1,500
			Dec. 31	" Balance c/d	61,000
1937 Jan. 1	To Balance b/d	61,000			

80,000 ORDINARY SHARES IN S LTD. ACCOUNT

		£			£	£
1936 June 30	To Cash, 80,000 shares @ 27s. 6d. . .	110,000	1937 Mar. 1	By Dividend for Year 1936, 10% . .	8,000	
				Less paid out of profits earned since date of acquisition 4%	3,200	
						4,800
				„ Balance c/d . .		105,200
1937 Mar. 2	To Balance b/d . .	105,200				

Note. Since the profits earned in 1936 amounted to £14,000 one-half thereof, or £7,000, must be presumed (in the absence of information to the contrary) to have been earned since H Ltd. acquired the shares.

Of this sum of £7,000, the preference dividend for the half year to 31st December, 1936, absorbs £3,000 (6 per cent on £100,000), leaving £4,000 for the ordinary shareholders.

This represents 4 per cent on the ordinary shares, hence £3,200 of the ordinary dividend received by H Ltd. can be credited to Profit and Loss Account, along with the preference dividend for the half year to 31st December, 1936.

A deficiency of assets in the subsidiary company at the date of acquisition of the shares would be made good out of subsequent profits, but the holding company would be justified in treating such profits as part of the current earnings of the combine, particularly if (as is usual in such cases) steps had been taken to reduce the capital of the subsidiary company, and the liquid position is satisfactory. Where losses are made subsequent to the acquisition, a reserve therefor should be made in the holding company's accounts, and deducted from the "Shares in Subsidiary Company" Account in the Balance Sheet, as such losses represent a reduction in the value of these shares. If the holding company takes credit for dividends of "good" subsidiaries but makes no reserve for

losses of "bad" ones, it is deliberately misstating the position.

Many methods are adopted in practice for incorporating the trading results of subsidiaries in the accounts of a holding company; the following are those usually adopted—

(*a*) *Wholly-owned Subsidiaries*

(i) Include in the Profit and Loss Account of the parent company the entire profits of the subsidiaries, whether such profits have been distributed as dividends or not. By this method the total profits earned by the organization as a whole are disclosed.

Profits not actually received by the holding company in the form of dividends are preferably stated separately in the Balance Sheet as "Undistributed Profits of Subsidiary Companies" from which transfers to Profit and Loss Account can be made from time to time as and when dividends are actually received from the subsidiary companies, the dividends themselves being debited to cash and credited to the Undistributed Profits of Subsidiary Companies Account.

If credit is taken for profits which may never be received as dividends, an asset is shown in the Balance Sheet of the parent company to which no legal claim exists, hence if the undistributed profits are credited to Profit and Loss Account it is the better practice to add a note to the Balance Sheet stating the amount of the profit included in the Profit and Loss Account which represents undistributed profits of subsidiaries.

(ii) Credit to the Profit and Loss Account of the

holding company only the amount of the dividend declared by the subsidiary company, the balance of the profit of the subsidiary company being ignored altogether. It is preferable to treat such dividends as profits of the holding company for the period in respect of which they are declared, ignoring the actual date of declaration.

Where the subsidiary declares a dividend of an amount less than its profits for the period, the accounts of the parent company will disclose a position less satisfactory than its actual position, thus, as already mentioned, creating a secret reserve. This is not necessarily a disadvantage, however. Due reserves are essential, of course; subject thereto, if desired, it may be arranged for the whole of the subsidiary's profits to be declared and paid as dividend, and for such sum as may be required as additional finance to be returned by the parent company on loan.

(iii) When losses have been made by a subsidiary company it is most desirable that provision should be made therefor in the accounts of the holding company. If such provision is not made, the true position of the organization will not be disclosed and the value of the investment in the subsidiary company may be overstated in the Balance Sheet of the parent company. It is definitely unsound to take credit for profits without reserving for losses.

The Companies Act, 1929, does not require the profits and losses of subsidiary companies to be dealt with in the accounts of the parent company in any specific manner. The Act merely requires the directors to append to the Balance Sheet a

statement specifying the manner in which such profits and losses have been dealt with in the parent company's accounts. A loss made by a subsidiary may have a considerable bearing upon the value of the parent company's investment in such subsidiary, but if the book value of the investment in the subsidiary is already less than the value of the shares after taking into consideration the loss incurred, the matter is, of course, not of the same importance.

(*b*) *Partially-owned Subsidiaries*

In these cases, regard should be had to the interests of the minority shareholders.

Obviously the whole of the profits of the subsidiary cannot be taken to the credit of Profit and Loss Account, whether declared as dividend or not. It is not even advisable to take credit for the holding company's proportion of such profits, as the asset created to the extent of the profits not yet declared as dividend would have an even more doubtful value than in the case of a wholly-owned subsidiary. The interests of the minority shareholders must be considered.

It is better, therefore, to take credit only for dividends actually declared. Losses should be provided for, for reasons already stated.

If the financial position of the subsidiary is worse than at the date of purchase, the holding company should make a reserve out of its own profits for the deficit of net assets, or reference should be made thereto on the holding company's Balance Sheet. Where, however, the position of the subsidiary companies, taken as a whole, has not changed for

the worse since the acquisition of the shares, there can be no objection to such shares being taken into the holding company's Balance Sheet at cost.

Unrealized inter-company profits included in the subsidiary company's accounts (e.g. where goods have been sold at a profit from a subsidiary to the holding company, but the holding company has not yet resold such goods; or one company in the group manufactures plant which it sells to another company therein as a fixed asset) should be eliminated from the holding company's accounts by the deduction thereof from the profit included in the Profit and Loss Account in respect of such subsidiary, and from the value of the Stock or Plant. Where such goods have been resold, however, the profit has been realized and no adjustment is necessary. Some authorities prefer to show separately a "Reserve for Unrealized Profits," instead of reducing the amount at which the asset appears in the Balance Sheet.

METHODS OF PRESENTATION OF PUBLISHED ACCOUNTS OF HOLDING COMPANIES

Since the main purpose of the holding company system is the exercise of control, it is desirable that the directors of the holding company should have prepared from time to time comprehensive statements showing the results and position of the combine, viewed as a whole. The shareholders of the holding company can form little idea of the real value of their holdings from a Balance Sheet of the holding company alone, in which shares in other companies (forming perhaps the bulk of the

assets) appear merely as "Investments in Subsidiary Companies," and only a statement of the aggregate indebtedness to and from subsidiary companies is given.

Much more detail must be available to the directors than it is essential to give to the members, to whom only summarized results need be given. Various methods of publishing accounts are adopted, the chief of which are explained hereunder—

(*a*) **Publication by the holding company of its "legal" Balance Sheet and Profit and Loss Account only, the interest in the subsidiaries being shown as an investment.**

The Companies Act, 1929, contains the following provisions as to the published accounts of holding companies—

Section 125. There shall be set out in the Balance Sheet of a holding company *separately from all its other assets and liabilities*—

(*a*) The *aggregate* of *shares* held in subsidiary companies;

(*b*) The *aggregate* of *indebtedness* (whether on account of loan or otherwise) of subsidiary companies to the holding company;

(*c*) The *aggregate* of *indebtedness* (whether on account of loan or otherwise) of the holding company to subsidiary companies.

Section 126. There shall be annexed to the balance sheet of a holding company a statement signed by the directors who sign the Balance Sheet, stating how the *aggregate profits and losses of subsidiary companies* have, so far as they concern the holding company, been dealt with in the accounts of the holding company, and, in particular, how and to what extent—

(*a*) Provision has been made for the losses of a subsidiary company either in the accounts of that company or of the holding company, or both; and

(*b*) Losses of a subsidiary company have been taken into

account in arriving at the profits and losses of the holding company as disclosed in its accounts.

Provided that it shall *not be necessary to specify* in such statement *the actual amount of the profits or losses of any subsidiary company*, or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner.

If, in the case of a subsidiary company, the auditor's report on the Balance Sheet of such company is qualified in any way, the statement annexed to the Balance Sheet of the holding company shall contain particulars of the manner in which the report is qualified.

Section 128. The total amount paid to directors of the holding company as remuneration by the holding company *and the subsidiary company* (exclusive of remuneration paid to a managing director of the holding company, and of any salary paid to any other director who holds any salaried employment in the company) shall be disclosed in the published accounts of the holding company.

The above are the *minimum legal requirements* as to the information with regard to subsidiary companies to be given in the published accounts of holding companies.

The following are examples of statements under Section 126 actually used in practice—

I. "Such of the aggregate profits of the subsidiary companies as are to be received in dividends are included in the above accounts so far as they concern this company. None of the subsidiary companies has sustained losses."

II. "In arriving at the profit for the year, profits of the subsidiary companies have been taken into account only to the extent of the dividends received during the year."

III. "Profits of subsidiary companies for their accounting periods ending within the period of this account have been included only to the extent

of the dividends declared and received or receivable by this company. Losses have been sustained by certain subsidiary companies for which no provision has been made in these accounts. The auditors' reports on the Balance Sheets of two of these companies contain qualifications regarding the value of certain assets. The aggregate undistributed profits of the other subsidiary companies exceed any such losses or depreciation."

It is interesting to note the form used in various published accounts and readers should watch these closely to see the practice adopted.

Where the Balance Sheets of subsidiary companies are made up to dates anterior to that of the holding company, the subsidiary companies may have made losses since the dates of their Balance Sheets. Although the directors of the holding company are not required by law to refer to such losses in their statement under Section 126, it would obviously be prudent for them to do so.

The advantages claimed for the presentation of a holding company's Balance Sheet in the above legal form are—

(1) The holding company may be viewed as a separate legal entity, without complicating the position by the disclosure of assets and liabilities of the subsidiary companies, which, although controlled by the holding company, are nevertheless, from a legal standpoint, separate concerns.

(2) From the creditors' point of view, the Balance Sheet, prepared in this way, is essential to enable them to form an opinion of the true financial position of the company against which they would have to proceed should occasion arise.

(3) If the holding company wishes to raise money by way of shares or debentures, it would have to prepare a Balance Sheet showing its own assets and liabilities alone, before any accurate opinion could be formed as to the security offered, although this might be supplemented by a statement of the net assets of the associated companies.

(4) The minimum amount of disclosure of the affairs of the company is made to competitors.

On the other hand, the following criticisms of the provisions of the Act have been made—

(1) Since only the aggregate amount invested in subsidiary companies is required to be shown without any indication as to the amount invested in any particular subsidiary, or as to the tangible assets and liabilities of the subsidiaries, it is impossible for members to form any opinion as to the security behind such holdings, or the extent to which they are represented by intrinsic value, and of the amount which has been paid for Goodwill.

(2) Since it is not necessary for the actual amounts of profits or losses of subsidiary companies to be disclosed in the accounts, members of the holding company may be left completely in the dark as to the success or otherwise of the policy of the holding company in making such investments, and heavy losses by subsidiaries may thus be concealed from the members.

(3) Since shares in subsidiary companies are normally fixed assets, there is not (apart from any special provisions in the company's Articles) any *legal* obligation upon the holding company to provide for depreciation of such investments by writing off losses sustained by the subsidiary companies.

(4) The Act makes no provision for a case where there are sub-subsidiary companies, i.e. where there are subsidiary companies *of* subsidiary companies, since the statement required by Section 126 does not require the directors to give any information as to the trading results of such companies. This omission facilitates still further the obscuration of the results of trading of the group as a whole. keeping in dark.

(5) Where profits of subsidiary companies are not paid to the holding company as dividends, but are accumulated year by year, without being taken into the holding company's books, there is a danger of the shares in the holding company being *under-valued*, and of members being induced to part with their shares at less than their true values, through being in ignorance of the exact position.

To remedy the above defects, it has been suggested that holding companies should be required by law to show the *actual value* of their investments in subsidiary companies at the date of the accounts in their Balance Sheets. Admittedly it would be impracticable to legislate as to the method to be adopted of arriving at such value, but the onus would then be on the directors to give an honest expression of opinion with regard thereto.

Shares in and indebtedness to and from *each* subsidiary should be shown, and not merely the aggregates of these amounts. Distinction should also be made between fixed and current indebtedness, e.g. between Debentures and balances due as the result of inter-company dealings.

Unless the auditor of the holding company were also the auditor of the subsidiary companies, he could not be held responsible for the valuation of the holdings, and it is therefore considered that the statement of value should appear, not on the Balance Sheet itself, but in a statement annexed thereto. The usefulness of the valuation would be enhanced if the directors were compelled to state their basis of working.

Alternatively, there should be stated on the face of the Balance Sheet the *total amount* of the ascertained profits or losses of subsidiary and/or sub-subsidiary companies appertaining to the interest of the holding company in such other companies, in so far as such profits or losses have not been brought into account in the Profit and Loss Account of the holding company.

A further alternative is that holding companies should be compelled by law to publish consolidated Balance Sheets, in which the combined assets and liabilities of the holding and the subsidiary companies are shown.

Many holding companies do, in fact, supplement their legal Balance Sheets, as explained in (*b*), (*c*), and (*d*) *infra*, but it is emphasized that such additional information is not required by law, and whether or not it is given, *the provisions of Sections* 125 *and* 126, *Companies Act*, 1929, as *outlined above, must be complied with.*

Illustrations. (1) *It has been suggested that the consolidation of the Accounts of a Holding Company, and its Subsidiary Companies, should be made compulsory by law.*

Discuss this suggestion.

The suggestion that the consolidation of the accounts of a holding company and its subsidiary companies should be made compulsory by law is one which is attracting a considerable amount of support in financial circles, and has much to recommend it.

Under the existing law the only disclosure required of a holding company, as to its interests in subsidiary companies, is that the aggregate of shares held in, and the aggregate of indebtedness to and by subsidiary companies must be set out separately in the holding company's Balance Sheet, whilst there must be annexed to such Balance Sheet a statement as to the manner in which the profits and losses of subsidiary companies have been dealt with for the purpose of the holding company's accounts, and the extent to which losses of subsidiary companies have been provided for; although it is not necessary to state the amount of any profits or losses of subsidiary companies which have been dealt with in any particular manner.

These requirements leave much to be desired, and, unless supplemented by further information, afford the members of the holding company and the public little or no information as to the real value of the holding company's interests in its subsidiary companies. The assets of a subsidiary company may consist, to a large extent, of such intangible items as goodwill, patents, and trade marks, the value of which is entirely dependent upon the continued ability of the company to earn profits, and it is considered that the members of the holding company should be furnished with

information, not only as to the directions in which their capital is employed, but also as to the extent to which it is being preserved intact.

One of the main criticisms of the present requirements is that not only is it unnecessary for any information to be given as to the *amount* of the profits or losses of subsidiary companies which has been dealt with in any particular manner, but that it appears to be obligatory to refer, in the statement to be annexed to the Balance Sheet, only to the manner in which profits or losses of the subsidiary companies for the year ended within the period covered by the holding company's accounts have been dealt with. The accounts of the subsidiary companies may include large amounts of profits or losses accumulated from past years, which have not been taken up in the holding company's accounts, and which may vitally affect the value of the parent company's holding in the subsidiaries, but as to the existence or amounts of such accumulations no information need be given.

It is submitted that these criticisms would be adequately met by making it compulsory for every holding company to lay before its members not only a balance sheet in the form at present required by law, but also a consolidated Balance Sheet of the company and of its subsidiaries, and a consolidated Profit and Loss Account of the whole group. The consolidated Balance Sheet should be required to disclose under appropriate headings the assets and liabilities of all the companies, sufficient information being given to indicate the nature of the assets and the basis upon

which the fixed assets have been valued. Where different bases of valuation have been employed by different members of the group, the amounts of the assets valued on each basis should be shown separately. The amount attributable to goodwill and other intangible assets should also be set out separately, whilst any inter-company indebtedness should be eliminated.

Where the holding company has not acquired the whole of the share capital of a subsidiary, the interests of minority shareholders can be indicated as a separate liability in the consolidated Balance Sheet. Alternatively, only the proportion of the assets and liabilities of each subsidiary attributable to the parent company's holding may be set out in the Balance Sheet.

In the consolidated Profit and Loss Account would be shown the earnings of the holding company and of all its subsidiaries, and also any balance of profit or loss brought forward from previous periods.

It is also submitted that the consolidated accounts should include the assets, liabilities, and profits of sub-subsidiary as well as subsidiary companies, so that no evasion of the provisions would be possible by the use of a device whereby concerns in which a company has a controlling interest are placed outside the operation of the requirements of the law in relation to the accounts.

If the publication of consolidated accounts on the above lines were made compulsory by law much more definite information would be available as to the state of the holding company's affairs,

and as to the manner in which the interests of its members were being promoted and protected.

Objections have been made to the proposals for the compulsory presentation of consolidated accounts on the grounds that a large measure of discretion ought to be left to the directors as to the form in which accounts are prepared. In the vast majority of companies the directors are competent and conscientious, and it would be detrimental to the interests of the members of those companies if the hands of the directors were tied and they were prevented by law from exercising their judgment as to the amount of disclosure necessary and desirable in any particular circumstances. It has also been submitted that, although a holding company may have a predominant interest in its subsidiaries, the assets of the subsidiaries are not legally the property of the holding company, whilst the consolidated Balance Sheet would not show to which particular assets the creditors and shareholders of each company would be entitled to look in satisfaction of their claims.

A further objection is that the accounts of foreign subsidiaries are sometimes difficult to reduce to a sterling basis, particularly in view of the standstill agreements and other restrictions operative in the case of certain foreign currencies.

To the first of these objections it may be replied that the form of the accounts required by law need not be so stereotyped as to hamper the discretion of the directors; the provisions should merely require compliance with general principles designed to prevent abuses. The second objection is

of a purely technical nature and fades into insignificance when considered in relation to the great benefits to the majority of shareholders which the provisions would entail. Moreover, it must be remembered that the consolidated accounts would not stand alone; they would merely be complementary to the separate Balance Sheets, in which the affairs of each company would be separately set out.

(2) *On* 1st *January Holding Ltd. acquired all the share capital of S Ltd., viz.* 100,000 *shares of* £1 *each, fully paid, at the price of* £126,500, *the price to be satisfied by the issue to the shareholders of S Ltd. of—*

> (*a*) 40,000 *shares of* £1 *each, fully paid, in Holding Ltd. at a premium of* 10s. *a share, and*
>
> (*b*) 700 4 *per cent Debentures of* £100 *each of Holding Ltd. at a discount.*

Before the issue of the above, the issued share capital of Holding Ltd. was 500,000 *shares of* £1 *each, fully paid, there was a General Reserve of* £150,000, *and balances of* £3,000, £4,000 *and* £8,000 *remained on Discount on Issue of Debentures, Underwriting Commission, and Premium on Shares Accounts respectively.*

At the Annual General Meeting of Holding Ltd., held on 15*th February, it was resolved to pay a dividend of* 20 *per cent and to make a bonus distribution of one share for every three held, appropriating for the latter purpose—*

> (1) *the whole of the General Reserve;*
>
> (2) *the Premium on Shares Account balance,*

after writing off against the latter the whole of the sums standing to the debit of Discount on Issue of Debentures and Underwriting Commission; (3) *from Profit and Loss Account, an amount equal to the balance (if any) of the bonus not provided for by* (1) *and* (2).

The dividend and bonus were distributable on the shares held at the date of the meeting and the distribution was made on 5th March.

Journalize the above transactions in the books of Holding Ltd., taking income-tax into account at 4s. 6d. in the £.

JOURNAL

		£	£
Jan. 1	Investment in S Ltd. Account . *Dr.*	126,500	
	Discount on Debentures Account .	3,500	
	To Share Capital Account . .		40,000
	,, Premium on Shares Account .		20,000
	,, Debentures Account . . .		70,000
	Acquisition of 100,000 Shares of £1 each in S Ltd. and issue of shares at a premium of 10s. each and debentures at a discount of 5% in settlement thereof.		
Feb. 15	Premium on Shares Account . *Dr.*	10,500	
	To Discount on Debentures Account		6,500
	,, Underwriting Commission Account		4,000
	Amounts written off against premiums.		
	Profit and Loss Appropriation Account . . . . *Dr.*	108,000	
	To Dividend Account . . .		108,000
	Dividend of 20% declared this day.		
	Dividend Account . . . . *Dr.*	24,300	
	To Income-tax Account . . .		24,300
	Tax on dividend at 4s. 6d. in £.		

JOURNAL—(*contd.*)

		£	£
	General Reserve Account . . *Dr.*	150,000	
	Premium on Shares Account . *Dr.*	17,500	
	Profit and Loss Appropriation Account . . . *Dr.*	12,500	
	To Bonus Account		180,000
	Bonus declared this day to be satisfied by the issue of one share for every three shares held.		
Mar. 5	Bonus Account . . . . *Dr.*	180,000	
	To Share Capital Account . .		180,000
	Allotment of bonus shares per minute of this day.		

(3)

ABRAHAM BROWN LTD.

31ST DECEMBER

		£			£
Share Capital, Authorized and Issued—			*Buildings, Plant, and Machinery* .		45,000
100,000 *Shares of £1 each* . .		100,000	*Patents, Trade-marks and Goodwill*.		50,000
Debenture Stock		5,000	*Investments—*		
Sundry Creditors . . .		26,000	*James James, Ltd.—* 10,000 *Shares of £1 each, at Cost* . .	£8,000	
Profit and Loss Account—			*Société de Bon Ton S.A. Paris—*10,000 *Shares of* 10 *Fcs. each, at Cost*	100	
Brought forward .	£5,000				8,100
Add Profit for year	2,000		*Stock-in-Trade*		20,000
		7,000	*Sundry Debtors, less Reserve* . .		13,900
			Cash in hand and at Bank . .		1,000
		£138,000			£138,000

JAMES JAMES LTD.

31ST DECEMBER

		£		£
Share Capital—			*Fixtures and Fittings* . . .	1,000
10,000 *Shares of £1 each* . .		10,000	*Stock-in-Trade*	2,500
General Reserve		4,000	*Loan—Abraham Brown, Ltd.* .	6,500
Loan—Société de Bon Ton . .		1,000	*Investments—*	
Sundry Creditors		2,500	51,000 *Shares of* 10 *Fcs. each in Société de Bon Ton S.A. Paris.*	600
Bank Overdraft (Guaranteed by Abraham Brown, Ltd.) . .		2,000	*Sundry Debtors*	7,400
Profit and Loss Account—			*Profit and Loss Account (per contra)*	1,500
Brought forward .	£1,500			
Less Loss for year .	3,000			
Deducted per contra.	1,500			
		£19,500		£19,500

SOCIÉTÉ DE BON TON S.A., PARIS
31ST DECEMBER

	Fcs.			Fcs.
Share Capital—		*Fixtures and Fittings*		100,000
100,000 Shares of 10 Fcs. each	1,000,000	*Stock-in-Trade*		400,000
Legal Reserve	100,000	*Loan—A. Brown, Esq.*		160,000
Current Account—		*Loan—James James, Ltd.*		80,000
Abraham Brown, Ltd.	16,000	*Sundry Debtors*		440,000
Sundry Creditors	340,000	*Investments—*		
		1000 Shares in Abraham Brown Ltd., at Cost		120,000
		Profit and Loss Account—		
		Brought forward	£50,000	
		Add Loss for Year	106,000	
				156,000
	Fcs. 1,456,000			Fcs. 1,456,000

DIRECTORATE

Abraham Brown Ltd.

	£
A. Brown, Chairman and Managing Director.	
Chairman's Fee	200
Director's Fee	500
Manager's Salary	2,000
	£2,700

	£
L. Brown, Director	500
Secretary	1,000
	£1,500

James James, Ltd.

	£
A. Brown, Chairman	400

	£
L. Brown, Managing Director.	
Director's Fee	400
Manager's Salary	600
	£1,000

	£
J. James, Director and Secretary.	
Director's Fee	400
Secretary's Salary	250
	£650

Société de Bon Ton, Paris.

	Fcs.
M. Petit, Managing Director	[1]100,000
A. Brown, Director's Fees	25,000
J. James, ,, ,,	25,000

[1] *As Manager—no Director's Fees.*

You are Auditors of Abraham Brown Ltd., and are presented with the above Balance Sheets and information.

Make any amendments or amplifications that you think fit in the Balance Sheet of Abraham Brown Ltd., and draft any necessary certificates, etc., to be annexed to comply with the Companies Act, 1929.

State what additional information, if any, you would require to be shown to comply with the regulations laid down by the Companies Act, 1929.

(*For the purpose of this question take* 80 *Francs* = £1.)

ABRAHAM BROWN LTD.
BALANCE SHEET AS AT 31ST DECEMBER

Capital and Liabilities		£	*Assets*	£
Share Capital, Authorized, Issued and Fully Paid—			Buildings, Plant and Machinery, at Cost, *less* Depreciation	45,000
100,000 Shares of £1 each		100,000	Patents, Trade-marks and Goodwill, at Cost, *less* Depreciation	50,000
Debenture Stock (Secured)		5,000	Investments in Subsidiary Companies, at Cost	8,100
Loan from Subsidiary Company		6,500	Amount owing by Subsidiary Company	200
Sundry Creditors		19,500	Stock in Trade	20,000
Profit and Loss Account—			Sundry Debtors, *less* Reserve for Doubtful Debts	13,700
Brought forward	£5,000		Cash in Hand and at Bank	1,000
Add Profit for year	2,000	7,000		
£		138,000	£	138,000

Notes. (1) There is a contingent liability in respect of a guarantee given to the bankers of James James, Ltd., a subsidiary company, for an overdraft, the amount of which on 31st December is £2,000.

(2) Directors' fees (including emoluments received by directors of the company from subsidiary companies) amount to £1,500.

Auditors' Report to the Members

We have audited the Balance Sheet of Abraham Brown Ltd. as above set forth and have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and

correct view of the state of the company's affairs according to the best of our information and the explanations given to us and as shown by the books of the company.

Statement by the Directors in Pursuance of Section 126, *Companies Act*, 1929

No profits of the subsidiary companies are included in the above accounts. During the year now ended the subsidiary companies made losses which have not been taken into account in arriving at the profits of Abraham Brown Ltd., but have been provided for in the accounts of the subsidiary companies.

The additional information required to be shown to comply with the regulations laid down by the Companies Act, 1929, is as follows—

(1) The basis of valuation of the fixed assets. (This has been assumed to be at cost less depreciation.)

(2) Whether the Debenture Stock, or any of the other liabilities of the company, are secured otherwise than by operation of law. (It has been assumed that the Debenture Stock is secured.)

(3) Whether any debentures have been redeemed and are available for reissue; if so, these must be shown in the accounts.

(4) Whether the loan from Société de Bon Ton S. A. Paris to A. Brown, Esq., is guaranteed by or made under a security given by Abraham Brown Ltd. If so, the fact must be disclosed in the accounts of Abraham Brown Ltd. (Section 128 (1).)

(5) Whether the auditors of the subsidiary companies, or either of them, have qualified their

reports attached to the Balance Sheets of the subsidiary companies. If so, the nature of the qualification must be indicated in the statement under Section 126.

Note. Certain of the assets of Abraham Brown Ltd. consist of shares in Société De Bon Ton S.A. Paris, and although Abraham Brown, Ltd., do not hold more than 50 per cent of the shares of Société De Bon Ton S.A., Paris, it is probable that they have, indirectly (i.e. through their controlling interest in James James Ltd.), the power to appoint the majority of the directors in the Paris company. It is therefore considered that that company is a subsidiary company of Abraham Brown, Ltd., within the meaning of Section 127, *Companies Act*, 1929 (*vide* Opinion of Counsel obtained by the Society of Incorporated Accountants and Auditors in November 1929).

(4) *The following balances are taken from the books of A. Public Company Ltd., as at 31st December—*

	£
Capital Authorized and Issued –	
500,000 7% *Cumulative Preference Shares of* £1 *each, fully paid*	500,000
500,000 *Ordinary Shares of* 10s. *each, fully paid*	250,000
Trade Creditors and Reserve for Income-tax	24,000
Amounts due to Subsidiary Companies	15,000
Unclaimed Dividends	750
Freehold and Leasehold Property (*Valuation at date of Balance Sheet*)	550,000
Plant and Machinery (*Cost, less Depreciation*)	250,000
Stocks and Stores in hand	40,000
Trade Debtors	14,000
Advances to Subsidiary Companies	24,000
Investments	30,000
Investments in Subsidiary Companies	35,000
Cash at Bank and in hand	15,550
Credit Balance from Trading Account	72,000
Interest and Dividends received	3,000
Transfer Fees	100
Directors' Fees	4,000
Provision for income-tax	14,500
Depreciation of Plant and Machinery	18,750
Profit and Loss Account: Credit Balance brought forward	13,075
Preference Dividend paid	27,125
Capital Appreciation of Freehold and Leasehold Property on revaluation	145,000

You are required to prepare Profit and Loss Account for the year and Balance Sheet as at 31st December (complying with the requirements of the Companies Act, 1929), and to append (a) *the Auditors' Report to the Members, with any qualifications you think necessary, and* (b) *a form of Statement* re *Subsidiary Companies as required by Section 126. Income-tax to be taken at 4s. 6d. in the £.*

A. PUBLIC COMPANY, LTD.
BALANCE SHEET AS AT 31ST DECEMBER

Liabilities	£	*Assets*	£
Capital Authorized and Issued—		Freehold and Leasehold Properties, as per valuation by Messrs. X	550,000
500,000 7% Cum. Pref. Shares of £1 each, fully paid	500,000	Plant and Machinery, at cost, *less* Depreciation	250,000
500,000 Ordinary Shares of 10s. each, fully paid	250,000	Shares in Subsidiary Companies, at cost	35,000
	750,000	Advances to Subsidiary Companies	24,000
Capital Reserve, being appreciation in value of Freehold and Leasehold properties on re-valuation	145,000	Investments, at cost	30,000
Trade Creditors and Reserve for Income Tax	24,000	Stocks and Stores in hand	40,000
Amounts due to Subsidiary Companies	15,000	Trade Debtors	14,000
Unclaimed Dividends	750	Cash at Bank and in Hand	15,550
Profit and Loss Account— Balance of Appropriation Account	23,800		
£	958,550	£	958,550

Report of the Auditors to the Members

We have audited the above Balance Sheet with the books, accounts and vouchers of the Company, and have received all the information and explanations we have required. The present value of the Shares in subsidiary companies is not, in our opinion, equal to the amount stated in the Balance Sheet. No reserve has been made for depreciation of other investments, which appear in the Balance Sheet at an amount in excess of their present market value. Subject to the above, we are of the

opinion that the Balance Sheet is properly drawn up, so as to exhibit a true and correct view of the state of the Company's affairs, according to the best of our information and the explanations given to us, and as shown by the books of the Company.

(Signed)

Incorporated Accountants.

STATEMENT IN ACCORDANCE WITH SECTION 126, COMPANIES ACT, 1929

No credit has been taken in the accounts of the A Public Company Ltd. for profits made by subsidiary companies. Two of the subsidiary companies have made losses, for which provision has been made in those companies' accounts, but no provision has been made in the accounts of the A Public Company Ltd.

The Directors of the A Public Company Ltd. have received directors' fees from the subsidiary companies amounting in the aggregate to £2,000.

(Signed)

.... }
.... } *Directors*

PROFIT AND LOSS ACCOUNT

YEAR ENDED 31ST DECEMBER

	£		£
To Directors' Fees	4,000	By Profit on Trading	72,000
" Depreciation of Plant and Machinery	18,750	" Interest and Dividends received	3,000
" Balance—Profit carried to Appropriation Account	52,350	" Transfer Fees	100
	£75,100		£75,100
To Income Tax	6,625	By Balance from Profit and Loss Account	52,350
" Dividend on Preference Shares	35,000	" Balance brought forward from last year	13,075
" Balance carried forward	23,800		
	£65,425		£65,425

Note. The Income Tax charged to the Profit and Loss Account is arrived at as follows —

	£
Balance per list	14,500
Less deduction from Preference Dividend £35,000 at 4/6	7,875
Charged	£6,625

(*b*) **Publication by the holding company with its own "legal" Balance Sheet of a copy of the Balance Sheet of each subsidiary.**

This method is not practicable where there is a large number of subsidiaries. Moreover, it adds to the difficulties of the shareholders in understanding the Balance Sheet, and compels them to wade through an unco-ordinated mass of figures, which may not be made up to the same date in each case, and which may be compiled on different bases.

Where the subsidiary companies are few in number, and draw up their accounts on similar bases and to the same date, then, provided the inter-company financial relationship is clearly shown, this method of presentation is more informative than method (*a*); but where the subsidiary companies are public companies, with "outside" shareholders, this method may be dangerous, inasmuch as competitors might thereby be given valuable information. Even where the Balance Sheets contain the above information, a true view of the affairs of the group as a whole cannot be obtained unless further information as to the position of each company on the date of acquisition of its shares, and any adjustment in the Investment Account for that company in the holding company's books, is also disclosed.

(*c*) **Publication by the holding company with its Balance Sheet of a separate summary of the assets and liabilities of all subsidiaries.**

By this method the holding company's Balance Sheet is published in "legal" form, and the separate statements enable the members to see the value of the investments, the amount of goodwill, and any surpluses or deficiencies not taken up in the holding company's Balance Sheet.

The amount of the interests of outside shareholders must, of course, be disclosed in such summaries, if they are to be of any use. Since the summaries are usually prepared in total only, the statements do not disclose how the assets and liabilities are spread over subsidiaries. This, however, is not important to a member of the holding company.

The chief difficulty in this, as in the preceding methods, is that the respective Balance Sheets may be made up to different dates, and complicated adjustments would then be necessary in order to arrive at a reliable summary on the date of presentation. Inter-company balances will be "cancelled out" as in the case of branch accounts. Inter-company profits must also be eliminated as already explained.

(*d*) **A Consolidated Balance Sheet is drawn up, in which the assets and liabilities of all the holding and subsidiary companies are amalgamated, as in the case of a branch business. This is merely a domestic Balance Sheet, prepared to show the state of the combination as a whole, and is published as a supplement to the "legal" Balance Sheet.**

This method enables the executive officers, to whom a *detailed* consolidated Balance Sheet is available, to see exactly the position of the combine as a whole, and enables the members, whose statement will be more condensed, to see the real value of their shares on a going concern basis. It enables them to see what surplus is available for dividend purposes, and how much of the capital invested is represented by Goodwill.

On the other hand, a Consolidated Balance Sheet may be objected to on the ground that it does not show which of the constituent companies are earning profits, and which are making losses. This may be important where the bulk of the profits are earned by a company which has small capital commitments, whereas other companies which have heavy liabilities in the form of debentures, etc., are making losses.

Where one of the subsidiaries is itself a holding company, a consolidated Balance Sheet is obviously much more easy to follow than separate Balance Sheets.

It must not be overlooked, however, that a consolidated Balance Sheet brings in assets and liabilities that are not legally those of the holding company, which has only an investment in shares of the subsidiary companies, to whom those assets, etc., legally belong.

The general idea underlying the preparation of a consolidated Balance Sheet may be said to be—

If the subsidiary company were wound up at once, *and* the assets realized their face value, the creditors would be paid, the outside shareholders would get their share of what was left, and the

balance would belong to the holding company. If, therefore, the holding company reserves in full for both creditors and the interests of outside shareholders, it can bring into the consolidated Balance Sheet all the assets of the subsidiary company.

Accordingly, all assets and liabilities are brought into the Balance Sheet, and reserve is made for the proportion of the net assets attributable to outside shareholders. Since the net assets must represent the capital plus undistributed profits, the reserve for outside shareholders is made up of their share capital plus the proportion of undistributed profits attributable thereto. The balance of the undistributed profits belongs to the holding company. If earned since the shares were acquired, such profits will be added to the holding company's own profits. If in existence prior to the date of acquisition, an adjustment is required, as will be explained.

The following points should be noted with regard to the preparation of a consolidated Balance Sheet—

(i) The Balance Sheets of all the companies must be made up to the same date. If the Balance Sheet of any subsidiary is made up to a different date, proper adjustments must be made to enable the exact position at the date of consolidation to be ascertained; stock-in-trade and profits can be estimated on the basis commonly adopted for the purpose of monthly accounts, and the other assets and liabilities obtained from the books.

(ii) All assets and liabilities must be classified and valued on similar bases, or adjustments made to bring them on to similar bases.

(iii) A consolidated Balance Sheet is merely the Balance Sheet of the holding company, in which, however, the item "Shares in Subsidiary Companies" is replaced by the actual assets and liabilities of the subsidiary companies, which represent such shares. The principle involved is similar to the preparation of the final accounts of a concern with branches, but where the price paid for the shares exceeds the book value of the actual net assets of the subsidiary as at the date of acquisition, such excess represents the price paid for Goodwill (subject to secret reserves, etc., as to which see (xii) below), and must be shown as such in the consolidated Balance Sheet, the other assets and liabilities being shown under their respective headings.

The following is a simple example—

Illustration. *The understated are the Balance Sheets of the H Co. Ltd., and the S Co. Ltd., on 1st January, on which date the H Co. Ltd. had acquired the whole of the share capital of the S Co. Ltd. at £2 per share.*

	H Co. Ltd.	*S Co. Ltd.*		*H Co. Ltd.*	*S Co. Ltd.*
	£	£		£	£
Share Capital	100,000	25,000	*Sundry Fixed Assets*	40,000	20,000
Reserve	25,000	5,000	*Sundry Floating Assets*	60,000	30,000
Creditors	15,000	15,000	*25,000 Shares in S Co. Ltd. at £2 per share*	50,000	
Profit and Loss Account	10,000	5,000			
£	150,000	£50,000	£	150,000	£50,000

It will be seen that the net assets of the S Co. Ltd. amount to £35,000, representing Share Capital £25,000, Reserve £5,000, and Profit and Loss Account £5,000. Had there been no Reserve or Profit and Loss Account balance, the net assets would merely have been the amount of the Share

Capital, £25,000; and the price paid for Goodwill would have been—

	£
Cost of Shares	50,000
Less Net Assets representing Share Capital	25,000
Excess Price paid	25,000
Since, however, the S Co. possesses further net assets, representing Reserves and Profits of	10,000
The price paid for Goodwill is reduced to	£15,000

The consolidated Balance Sheet would therefore consist of the holding company's Balance Sheet, in which the Investment of £50,000 is replaced by the assets and liabilities of the S Co. Ltd., as shown above, and by £15,000 under the heading of "Goodwill."

(iv) If the holding company does not own the whole of the capital of the subsidiaries, the consolidated Balance Sheet must show as a liability the total interests of all outside shareholders in the subsidiaries. Thus, in the above example, if the H Co. Ltd. had acquired only 20,000 of the shares in the S Co. Ltd., at a cost of, say, £40,000, there would appear as a liability in the consolidated Balance Sheet—

	£	£
Proportion of S Co. Ltd., capital held by outside shareholders		5,000
Proportion of Reserves and Profits of S Co. Ltd. attributable to outside shareholders—		
⅕th of Reserve	1,000	
⅕th of Profit and Loss Account	1,000	
		2,000

Under the heading of Goodwill would appear—

	£
Cost of Shares	40,000
Less Nominal Value	20,000
	20,000
Less Proportion of Reserve and Profit and Loss Account attributable to H Co.'s holding in S Co. Ltd.—	
⅘ths of £10,000	8,000
Goodwill	£12,000

It will be observed that only the holding company's proportion of Goodwill, arising on the purchase of shares in a subsidiary company, is brought into the consolidated Balance Sheet. This follows the general rule that Goodwill should not be brought in at a figure in excess of cost. It is not considered incorrect, however, to bring in the full amount, showing the outside shareholders' proportion as a reserve on the other side of the Balance Sheet, but this treatment is most unusual.

Illustrations. (1) *What do you understand by* (*a*) *the Legal Balance Sheet, and* (*b*) *the Consolidated Balance Sheet, of a holding company?*

(*a*) The *Legal Balance Sheet* of a holding company is the Balance Sheet which, by the *Companies Act*, 1929, every company incorporated under the Companies Act is required to lay before its members in general meeting. In the case of a holding company such Balance Sheet must show separately from other items—

(i) The aggregate of investments in subsidiary companies.

(ii) The aggregate of loans to, or indebtedness of, subsidiary companies.

(iii) The aggregate loans from, or indebtedness to, subsidiary companies.

A statement, signed by the directors, must be annexed to the Balance Sheet of a holding company stating how the profits and losses of the subsidiary companies have been dealt with in the accounts of the holding company, and reciting details of any qualifications in the report of the auditors of any subsidiary company.

(*b*) Owing to the paucity of information supplied

by the legal Balance Sheet, many holding companies provide their members, in addition, with a *Consolidated Balance Sheet.* This Balance Sheet is not required by law but is prepared to disclose the financial position of the holding company and its subsidiaries as a whole.

The consolidated Balance Sheet contains particulars of the assets and liabilities of the holding company and its subsidiaries. Where some of the shares in the subsidiary companies are owned by outside shareholders, the interests of such shareholders may be shown as a liability in the consolidated Balance Sheet. Alternatively, the consolidated Balance Sheet may contain only such proportion of the assets and liabilities of the subsidiary companies as is attributable to the shares therein held by the holding company.

Sometimes only the proportion of each separate asset and liability which is attributable to the capital in the subsidiary company held by the holding company is included in the consolidated Balance Sheet, the interest of the outside shareholders being entirely eliminated. This latter method, however, may lead to complications, e.g. in dealing with inter-company loans, and is not to be recommended.

(2) *The following represents the Balance Sheet (abridged) of the Omega Co. Ltd., as at* 31*st December*—

	£		£
Authorized and Issued Capital:		*Sundry Assets*	74,000
10,000 *Pref. Shares of £1 each fully paid*	10,000		
50,000 *Ord. Shares of £1 each fully paid*	50,000		
Sundry Creditors	8,000		
Reserve Fund	5,000		
Profit and Loss Account	1,000		
	£74,000		£74,000

The Alpha Co. Ltd., a holding company, acquired on the above-named date, 60 per cent of the Ordinary Share Capital of the Omega Co. at a cost of £39,000.

Assuming you were instructed to prepare a Consolidated Balance Sheet for the holding company and its subsidiary, explain how the figures relating to the Omega Company would be entered therein.

Note. The Preference Shares shown above do not carry any voting rights or the right of participation in surplus assets.

In the Consolidated Balance Sheet of the holding company and its subsidiary the sundry assets and sundry creditors of the subsidiary company would appear as such at their book values. A reserve would be made for the interests of outside shareholders as follows—

	£	£
Proportion of Share Capital of Subsidiary Company attributable to outside members—		
10,000 Preference Shares of £1 each, fully paid	10,000	
20,000 Ordinary Shares of £1 each, fully paid	20,000	
		30,000
Proportion of Reserves and Undistributed Profits attributable to Outside Members, 40% of Capital Reserve (see below)		2,400

The Reserve Fund and Profit and Loss Account balances would be transferred to a Capital Reserve since, on the date of acquisition of the interest in the subsidiary company, the holding company pays for its share of the assets representing these items, which are therefore capital items from the holding company's point of view. Of this Capital Reserve, however, 40 per cent belongs to outside members. The Capital Reserve appears inset on the liabilities side of the Consolidated Balance Sheet, thus—

	£
Capital Reserve, being Reserves and Undistributed Profits at date of acquisition of shares in subsidiary company—	
Reserve Fund	5,000
Profit and Loss Account	1,000
	6,000
Less Proportion attributable to Outside Members, 40%	2,400
Deducted, *per contra*, in arriving at Goodwill	£3,600

The amount paid for Goodwill in acquiring the shares is shown as an asset, and is arrived at thus—

	£
Cost of Shares in Subsidiary Company	39,000
Deduct Nominal Value thereof	30,000
	9,000
Deduct Proportion of Assets representing undistributed profits, as per Capital Reserve *contra*	3,600
Goodwill	£5,400

Note. It has been assumed that the Preference Dividend has been paid up-to-date, therefore no profits need be set aside in respect of such a dividend.

Where a company takes over another, any excess of the net assets over the purchase price is taken to Capital Reserve. Similarly, where shares are bought at a date when there are undistributed profits, such profits are of the nature of capital, as already explained. Accordingly, in the Consolidated Balance Sheet it is useful to credit all Reserves and Profits of the subsidiary existing at the time of the acquisition of the controlling interest to a Capital Reserve, and then to transfer therefrom to the liability to outside shareholders the proportion attributable to their holding. The balance of this Reserve is the holding company's proportion, for which it paid the excess of the cost price of the shares acquired over their nominal

value, and is set against such excess in arriving at goodwill. If this proportion is more than such excess, a capital reserve results. (See illustrations later in the chapter.)

(vi) Where the nominal value of the shares acquired exceeds their cost price, the amount of the excess will be added to the Capital Reserve referred to in (v), *after* the proportion attributable to outside shareholders has been transferred to the liability to outside shareholders.

Where there was a debit balance on Profit and Loss Account at the date of acquisition, the holding company's proportion thereof must be added to Goodwill (or deducted from Capital Reserve as the case may be).

(vii) Reserves and Profit and Loss Account balances of the subsidiary will probably include profits earned since the acquisition of the shares. Such profits are divisible between the holding company and the outside shareholders, the holding company's proportion being transferred to the Consolidated Profit and Loss Account, and the outside shareholders' proportion to the Liability to Outside Shareholders. Only the reserves and profits in existence at the date of the acquisition are taken to Capital Reserve, all subsequent profits being properly taken to Revenue.

(viii) Where preference shares in subsidiary companies are not held by the holding company, the nominal value of the preference shares not so held should be transferred to the Liability to Outside Shareholders. If the preference shareholders are entitled under the articles of the company to participate in any surplus of assets on liquidation,

it is sometimes contended that they should be credited with a part, proportionate to their shareholding, of the surplus assets remaining, after deducting the total of the ordinary and preference shares from the net assets of the subsidiary company (i.e. of the balances of Reserve and Profit and Loss Account). The Consolidated Balance Sheet, however, is intended to show the position of affairs as at a certain date, and not to reflect what might happen in the event of liquidation, and since, so long as the subsidiary company is a going concern, the undistributed profits belong to the ordinary shareholders, and might be distributed as dividends to the ordinary shareholders prior to the liquidation, it is thought that such a provision of a share in surplus is unnecessary. A note on the Consolidated Balance Sheet of the possible liability to the preference shareholders might be added, if desired, to meet the case. The actual preference dividend accrued to the date of the Consolidated Balance Sheet should, of course, be transferred from Profit and Loss Account to the liability to outside Preference Shareholders, since the aim is to show clearly the profits attaching to the combine.

(ix) Inter-company indebtedness would inflate both sides of the Balance Sheet and must therefore be set off and not included either as an asset or as a liability in the Consolidated Balance Sheet. For example, if a holding company is indebted to its subsidiary company for goods, £6,000, or if one subsidiary is similarly indebted to another, such indebtedness must be eliminated on both sides of the Consolidated Balance Sheet.

In the case of the subsidiary companies, this will usually mean a deduction from creditors or debtors, and can be shown inset on the detailed Consolidated Balance Sheet.

(x) Where Bills, drawn by one of the companies in the group and accepted by another are still held by the drawer company, they will appear as an asset in one Balance Sheet and as a liability in the other, and will accordingly not appear in the Consolidated Balance Sheet. Where, however, certain of the Bills have been discounted by the drawer company, and have not matured at the date of the Balance Sheet, they represent an external liability of the combine, and must be shown as such in the Consolidated Balance Sheet. Thus, if the holding company has drawn Bills for £10,000 on the subsidiary, and has discounted £8,000 of such Bills, there will appear in the holding company's Balance Sheet Bills Receivable of only £2,000, whereas the corresponding liability for Bills Payable in the subsidiary company's Balance Sheet will be £10,000. The inter-company liability is therefore only £2,000, which amount will be set off in the Consolidated Balance Sheet, the external liability to the holders of the Bills for £8,000 being shown therein.

(xi) Inter-company profits, included in stocks, should be deducted from Profit and Loss Account, and from the appropriate assets, so as to reduce these items to their cost to the combine. When there are outside shareholders, only the holding company's proportion of such profit should be eliminated, since from the point of view of the outside shareholders, the profit has been realized,

and to the extent that the profit belongs to outside shareholders it increases the cost of the goods to the combine.

For example, if the holding company's stock of £15,000 includes goods purchased from the subsidiary company to the value of £9,000, the cost of such goods to the subsidiary company being £8,000, and the holding company holds nine-tenths of the capital of the subsidiary, the following adjustment will be necessary in the Consolidated Balance Sheet—

	£	£
Stock: Holding Company	15,000	
Less nine-tenths of Profit taken by Subsidiary Company on Goods sold to Holding Company, viz. nine-tenths of £1,000	900	
		14,100

The unrealized profit of £900 so eliminated must also be deducted from the holding company's proportion of the subsidiary company's profit, which is credited to the Consolidated Profit and Loss Account.

If one subsidiary company has manufactured and sold plant to another company in the group for use by the latter as a fixed asset, here again the profit must be adjusted, being deducted from the value of the plant and from the Profit and Loss Account of the vending company.

In both cases, there is a strong feeling on the part of many authorities that the unrealized profit would be better shown as a specific reserve on the liabilities side of the Balance Sheet rather than as a deduction from the asset.

(xii) Assets of the subsidiary company are frequently revalued for the purpose of arriving at the price to be paid for the shares, but no adjustment

is made in the books of the subsidiary company. Where this is the case, it is preferable to include in the consolidated Balance Sheet the difference in value as a specific addition to or deduction from the assets affected, increasing or decreasing the Capital Reserve accordingly. The liability to outside shareholders will then be automatically adjusted when transferring to them their proportion of the Capital Reserve.

If provision for depreciation has been made on the book value of the assets in question, it must not be forgotten that any such increase or decrease in value will necessitate an adjustment of the charge for depreciation in the consolidated Profit and Loss Account, and such adjustment must be made, *before* arriving at the proportion of the profits attributable to outside shareholders.

For example, if the plant and machinery standing in the books of the subsidiary company at £5,000 had been revalued, for the purpose of fixing the price of the shares purchased, at £7,000, and depreciation had been written off in the books of the subsidiary company at the rate of 10 per cent on the book value of £5,000 only, the subsidiary company's plant and machinery would be shown in the Consolidated Balance Sheet as—

		£	£
Plant at cost, per books		5,000	
Less Depreciation		500	
		4,500	
Add Excess of Valuation over book value	2,000		
Less Depreciation	200		
		1,800	
			6,300

whilst the following adjustment would be necessary in the Consolidated Profit and Loss Account

at the end of the first year after the acquisition of the shares—

	£
Profit of Subsidiary Company (say)	5,400
Less Additional Depreciation on Plant—10 per cent on £2,000	200
	£5,200

The outside shareholders will automatically be charged with their proportion of the increased depreciation since their share of profit will be based on the reduced amount of £5,200.

Care must be taken to see that the adjustment is properly computed. Where the consolidation takes place several years after the purchase, particularly where the reducing instalment system of depreciation is employed, e.g. at the end of the second year, it would not be correct to write off 20 per cent from the excess over the book value; the amount to be written off would, in fact, be 19 per cent on the reducing instalment (£100 — £10 = £90; £90 — £9 = £81). Where plant is overstated in the books as compared with the valuation, the excess depreciation written off must be added to the Profit and Loss Balance before arriving at the outside shareholders' proportion thereof.

(xiii) In order that the true profits can be shown, it is essential that there be prepared a consolidated income statement. Such a statement is invaluable in those cases where a consolidated Balance Sheet is not prepared and is essential where such a Balance Sheet is prepared. In the consolidated Profit and Loss Account the proportion of the profit or loss attributable to outside shareholders

must be deducted and included in the liability to outside shareholders in the consolidated Balance Sheet. Any inter-company dividends, purchases, sales and expenses shown in the respective Profit and Loss Accounts will form contra items in the consolidated Profit and Loss Account, and will be set off therein in the same way as inter-branch transfers are set off in Branch Accounts.

(xiv) The legality of a subsidiary company holding shares in the holding company is doubtful, but where it does the nominal value of such shares should be deducted from the issued Share Capital of the holding company, as it represents inter-company "indebtedness." Any premium paid in the purchase of such shares should be deducted from the "Premium on Shares Account" (to the extent that it is included therein) in the consolidated Balance Sheet, or, if there is no Premium on Shares Account, added to Goodwill. If any undistributed profits stood in the holding company's books at the date when such shares were required, the proportion thereof attributable to the shares will, however, be deducted in the holding company's Profit and Loss Account and not added to Goodwill. Any excess of the price over the items already mentioned must be added to Goodwill. An adjustment for profits earned since is practically impossible and should be covered by a note.

(xv) Where a subsidiary company holds shares in another subsidiary, or in a sub-subsidiary company, e.g. where a subsidiary is itself a holding company, the Balance Sheets of the subsidiaries and sub-subsidiary companies should first be

amalgamated before consolidating them with the Balance Sheet of the holding company. The rules of procedure outlined above will be applied in amalgamating the Balance Sheets of the subsidiary and sub-subsidiary companies. If the companies are few in number, the whole can be amalgamated at once, but where the number of companies is large, this would be impracticable.

(xvi) Where a holding company or a subsidiary holds shares in companies which are not controlled, such holdings would appear as investments only. What constitutes control is a question of fact in each case, e.g. control may be obtained by the acquisition of a small proportion of the total capital, where the particular class of shares held carries the bulk of the voting power; conversely, the holding of the bulk of the share capital may not give control, when the remaining shares carry the voting power. Where it is decided not to bring into the consolidated Balance Sheet the assets and liabilities of a company because of lack of a controlling interest therein, care must be taken to reserve for losses.

Illustrations. (i) *Consolidate the following Balance Sheets—*

	H	S		H	S
	£	£		£	£
Capital £1 shares	1,400	1,000	*900 shares in S at cost*	1,200	
Creditors		500	*Sundry Assets*	200	1,800
Profit and Loss Account		300			

When H Ltd. acquired the shares in S, the Profit and Loss Account of the latter had a credit balance of £200.

CONSOLIDATED BALANCE SHEET

	£	£
Capital		1,400
Outside Shareholders' Interest in Subsidiary-Capital . .	100	
Profits—		
Capital Reserve . . £20		
Profit and Loss Account 10	30	130
Capital Reserve, being undistributed profits at date of acquisition of shares .	200	
Less Outside Shareholders' Proportion—one-tenth .	20	
Deducted contra . .	£180	
Creditors		500
Profit and Loss Account S .	300	
Less Amount at date of acquisition transferred to Capital Reserve . . .	200	
Profits made since . .	100	
Less Outside Shareholders' Proportion—one-tenth .	10	90
		£2,120

	£	£
Goodwill, being excess of cost of shares over net assets acquired—		
Cost of shares . . .	1,200	
Less Nominal Value .	900	
	300	
Less Undistributed Profits from Capital Reserve contra	180	120
Sundry Assets		2,000
		£2,120

4) *Consolidate the following Balance Sheets—*

	H £	S £		H £	S £
Capital £1 shares . .	1,600	2,000	*1,800 shares in S* . . .	1,600	
Creditors		800	*Sundry Assets* . . .		2,400
			Profit and Loss Account .		400

At the date of acquisition, S had a debit balance on Profit and Loss Account of £300.

CONSOLIDATED BALANCE SHEET

	£	£
Capital		1,600
Outside Shareholders' Interest in Subsidiary-Capital . .		200
Capital Reserve, being excess of nominal value of shares over cost—		
Nominal	1,800	
Cost	1,600	
To Contra . . .	200	
Creditors		800
		£2,600

	£	£
Goodwill, being proportion of loss acquired less excess of nominal value of shares over cost thereof—		
Loss (see below) . .	270	
Less Capital Reserve .	200	70
Sundry Assets		2,400
Profit and Loss Account .	400	
Less Balance at date of acquisition (see below). .	300	
	100	
Less outside shareholders' proportion—one-tenth .	10	90
Loss at date of acquisition .	300	
Less Outside Shareholders' Proportion—one-tenth .	30	
Transferred to Goodwill .	270	
Outside Shareholders proportion of Losses (£10 + £30) .		40
		£2,600

(3) *Consolidate the following Balance Sheets—*

	H	S		H	S
	£	£		£	£
Capital £1 shares . . .	2,400	1,600	1280 *Shares in S* . .	1,000	
Creditors . . .		300	*Sundry Assets* . . .	1,400	1,950
Profit and Loss Account .		50			

On the date of acquisition, S had a debit *balance on Profit and Loss Account of* £100.

CONSOLIDATED BALANCE SHEET

	£	£		£	£
Capital		2,400	Sundry Assets . .		3,350
Outside Shareholders' Interest in Subsidiary-Capital . .	320				
Profits—					
Profits since acquisition per Profit and Loss Account . 30			Loss at date of acquisition, per contra	100	
Less Loss at date of acquisition . . 20			*Less* Outside Shareholders' Proportion one-fifth . .	20	
	10		To Capital Reserve. .	£80	
		330			
Creditors		300			
Profit and Loss Account— Balance	50				
Add Loss at date of acquisition transferred to contra	100				
	150				
Less Outside Shareholders' Proportion one-fifth .	30				
		120			
Capital Reserve, excess of Nominal Value of Shares acquired over cost thereof					
Nominal	1,280				
Less Cost . . .	1,000				
	280				
Less Proportion of Loss at date of acquisition per contra	80				
		200			
		£3,350			£3,350

(4) *The following are the Balance Sheets of a parent company (X) and its subsidiary (Y).*

X LTD.

BALANCE SHEET, 31ST OCTOBER

Capital and Liabilities		£	*Assets*		£
Authorized Capital—			*Land and Buildings (Cost, less Depreciation)*		26,400
160,000 *Shares, £1 each*		160,000	*Plant and Machinery (do.)*		51,870
Issued Capital—			*Fixtures and Fittings (do.)*		5,750
135,000 *Shares £1 each, fully paid*		135,000	*Investment in Subsidiary Company (at Cost)—*		
5% *Debentures (carrying a floating charge)*		28,000	*Y Ltd.* 75,000 *Shares*		86,250
Trade Creditors		14,350	*Stocks on Hand*		30,960
General Reserve Account		30,000	*Sundry Debtors—*		
Profit and Loss Account		33,183	*Y Ltd.*	£10,205	
			Other Trade A/cs	17,735	
					27,940
			Cash		11,363
		£240,533			£240,533

Y LTD.

BALANCE SHEET, 31ST OCTOBER

Capital and Liabilities		£	*Assets*	£
Authorized Capital—			*Land and Buildings (Cost, less Depreciation)*	18,000
150,000 *Shares, £1 each*		150,000	*Packing Presses (do.)*	2,380
Issued Capital—			*Fixtures and Fittings (do.)*	570
100,000 *Shares £1 each, fully paid*		100,000	*Stocks on Hand*	45,000
Sundry Creditors—			*Trade Debtors*	60,000
X Ltd.	£9,665		*Bills Receivable*	3,504
Other Trade Accounts	22,335		*Cash*	22,546
		32,000		
Profit and Loss Account		20,000		
		£152,000		£152,000

The holding of the parent company in Y Ltd. was acquired some years earlier at a premium of 3s. *per share, the balance at credit of the Profit and Loss Account of Y Ltd. being* £10,000.

Transactions between parent and subsidiary include the purchase of goods by Y Ltd. at cost plus 33⅓ *per cent. The stock of Y Ltd. on* 31*st October consisted of—*

Goods purchased from X Ltd.	£15,008	
" " *other sources*	29,992	
		£45,000

Cash amounting to £540 was in transit from Y Ltd. to X Ltd. at the close of business on 31st October.

You are required to prepare the consolidated Balance Sheet to be presented to the shareholders of X Ltd. showing the position on 31st October.

CONSOLIDATED BALANCE SHEET OF X LTD. AND ITS SUBSIDIARY COMPANY Y LTD.

As at 31st October

Capital and Liabilities			£
Authorized Capital—			
160,000 shares of £1 each			160,000
Issued Capital—			
135,000 shares of £1 each, fully paid			135,000
Proportion of Share Capital of Subsidiary Company held by Members outside the combine			25,000
5% Debentures (carrying a floating charge)			28,000
Proportion of undistributed Profits of Subsidiary Company attributable to Members outside the Combine—			
Capital Reserve (see below)		£2,500	
Profit and Loss Account (see below)		2,500	
			5,000
Trade Creditors—X Ltd.		14,350	
Y Ltd.		22,335	
			36,685
Capital Reserve, being undistributed Profits of Y at date of acquisition of the shares therein—			
Transfer from Profit and Loss Account		£10,000	
Less Transfer to outside Members		2,500	
Deducted from Goodwill contra		£7,500	
General Reserve Account			30,000
Profit and Loss Account—			
X Ltd.		£33,183	
Y Ltd.	£20,000		
Less Transfer to Capital Reserve	10,000		
	10,000		
Less Transfer to outside Members	2,500		
	7,500		
Less Unrealized profit included in Stock on hand, Y Ltd.	2,814		
		4,686	
			37,869
£			297,554

Assets			£
Goodwill, being excess of cost of Shares in Y Ltd. over the share of net Assets attributable thereto—			
Cost		£86,250	
Less Nominal Value		75,000	
		11,250	
Less Proportion of undistributed Profits at date of acquisition, per Capital Reserve (contra)		7,500	
			3,750
Land and Buildings (cost less depreciation)—			
X Ltd.		£26,400	
Y Ltd.		18,000	
			44,400
Plant and Machinery (cost less depreciation)			51,870
Packing Presses (cost less depreciation)			2,380
Fixtures and Fittings (cost less depreciation)—			
X Ltd.		£5,750	
Y Ltd.		570	
			6,320
Stocks on hand—			
X Ltd.		30,960	
Y Ltd.	£45,000		
Less Unrealized Profit of combine, 75% of 25% of £15,008	2,814		
		42,186	
			73,146
Sundry Trade Debtors—			
X Ltd.		17,735	
Y Ltd.		60,000	
			77,735
Bills Receivable			3,504
Cash—X Ltd.		11,363	
Y Ltd.		22,546	
In transit		540	
			34,449
£			297,554

Note. The "inset" figures would not usually be shown in the published accounts, but are included above to show how the final figures are arrived at.

(5)

H CO LTD

	£		£
Capital, Issued and Fully Paid	1,400	*Investment—*	
Creditors	350	900 *Shares of £1 each fully paid in S Ltd., at cost*	1,125
Profit and Loss Account	260	*Sundry Assets*	885
	£2,010		£2,010

S LTD.

	£		£
Capital, Issued and Fully Paid	1,000	*Sundry Assets*	1,510
Creditors	190		
Profit and Loss Account	320		
	£1,510		£1,510

On the date when the H Co. Ltd. acquired the shares in S Ltd., the credit balance on the latter's Profit and Loss Account was £220. No dividends have been declared since that date. Prepare a consolidated Balance Sheet.

It is convenient, until the general principles of consolidation have been thoroughly mastered, to imagine that the purpose is to bring the balances of S Ltd. into the books of H Co. Ltd., in the same way as if S Ltd. were a branch concern.

The cost of the investment in the "Branch" is £1,125. What does this represent? To see clearly the method of approach, build up an "account" of the investment, similar to writing up a Branch Account, viz.—

S LTD. "ACCOUNT"

		£					£
To Cost of Shares		1,125	By Sundry Assets				1,510
" Minority Capital		100	" Goodwill—				
" Minority Profits (see contra and below)		32	Cost of Shares			£1,125	
" Sundry Creditors		190	*Less* Shares bought		900		
" Profit and Loss Account—profits made since shares acquired	£100		Profits at that date	220			
Less Minority—one-tenth	10		*Less* Minority	22			
		90			198		
						1,098	
							27
		£1,537					£1,537

The above idea having been grasped, it is, of course, more direct to make the adjustments in the Consolidated Balance Sheet itself, as follows—

CONSOLIDATED BALANCE SHEET OF H CO. LTD. AND ITS SUBSIDIARY S LTD.

			£		£	£
Capital			1,400	Goodwill, being excess of cost of Shares in the Subsidiary Company over the share in the net assets attributable thereto—		
Proportion of subsidiary company's Capital attributable to the outside minority shareholders . . .			100	Cost	1,125	
Proportion of profits of subsidiary so attributable—				*Less* Nominal Value .	900	
Capital Reserve .		£22		Amount paid for profits, etc.	225	
Profit and Loss Account .		10	32	*Deduct*: Share of profits per Capital Reserve contra . . .	198	27
Capital Reserve—				Sundry Assets—		
Profits at date of acquisition of the shares in the subsidiary company . . .		220		H Co. Ltd. . .	885	
Less Attributable to Minority		22		S Ltd. . .	1,510	2,395
To Contra . .		£198				
Creditors—						
H Co. Ltd. . . .		350				
S Ltd.		190	540			
Profit and Loss Account—						
H Co. Ltd. . .		260				
S Ltd. . . .	320					
Less Profits at date of acquisition of shares transferred to Capital Reserve . .	220					
	100					
Less Attributable to Minority . .	10	90	350			
			£2,422			£2,422

(6) The Directors of Parent Ltd. desire to present to the members a consolidated Balance Sheet as on 31st December of the whole undertaking, incorporating the company's interest in the assets and liabilities of A Ltd. and B Ltd.

Draft such a Balance Sheet, showing your detailed workings in an inner column.

The following is an abstract of the draft Balance Sheets of the three companies as on 31st December.

[*continued on page* 356]

CONSOLIDATED BALANCE SHEET OF PARENT LTD. AND ITS SUBSIDIARY COMPANIES

As at 31st December

Capital and Liabilities

	£	£	£
Share Capital, Parent Ltd.—Ord. Shares of £1 each			200,000
Proportion of Share Capital of Subsidiary Company held by Members outside the combine			25,000
5% First Mortgage Debentures, B Ltd., guaranteed by Parent Ltd.			55,000
Capital Reserve, B Ltd.—			
Capital Redemption Reserve Fund		10,000	
Profit and Loss Account (see below)		8,000	
		18,000	
Less Proportion attributable to A Ltd., one-half		9,000	
		9,000	
Proportion of B Ltd. Capital Reserve attributable to A Ltd. (as above)	9,000		
Less Attributable to A Ltd. outside Members—one-fourth	2,250		
		6,750	
Carried to Goodwill contra		£15,750	
Sundry Creditors—			
Parent Ltd.	£80,000		
A Ltd.	40,000		
B Ltd.	20,000		
			140,000
Bills Payable, A Ltd.		16,000	
Less held by Parent Ltd.		8,000	
			8,000

Assets

		£	£	£	£
Goodwill: Parent Ltd.				3,000	
A Ltd.			18,000		
Cost of Shares in A Ltd.		75,000			
Less Premium on Shares issued in Exchange		25,000			
		50,000			
Less Nominal Value		75,000			
		Cr. 25,000			
Less Loss at date of Acquisition	£8,000				
Less Attributable to outside members	2,000				
		6,000			
			Cr. 19,000		
			Cr. 1,000		
Cost of Shares in B Ltd.		100,000			
Less Nominal Value		50,000			
		50,000			
Less Capital Reserve, per contra		15,750			
			34,250		
				33,250	
					36,250
Investments at cost					20,000
Land, Buildings, Plant and Machinery, at Cost—					
Parent Ltd.			44,000		
A Ltd.			40,000		
B Ltd.			35,000		
					119,000

Profit and Loss Account—Parent Ltd.		75,000	
B Ltd.	£15,000		
Less Profit at date of acquisition of Shares, transferred to Capital Reserve	8,000		
	7,000		
Less Attributable to Shares held by A Ltd.—one-half	3,500		
		3,500	
		78,500	
Less A Ltd. Profit and Loss Account, per contra		3,375	
			75,125
			£503,125

Stocks—			
Parent Ltd.	50,000		
A Ltd.	25,000		
B Ltd.	20,000		
			95,000
Sundry Debtors—			
Parent Ltd.	90,000		
A Ltd.	5,000		
B Ltd.	35,000		
			130,000
Balances at Bankers—			
Parent Ltd.	60,000		
A Ltd.	2,000		
B Ltd.	40,000		
			102,000
Profit and Loss Account, A Ltd.	16,000		
Less Profits of B Ltd. attributable to holding of A Ltd., per contra	3,500		
	12,500		
Less Loss at date of acquisition of shares transferred to Goodwill	8,000		
	4,500		
Less Attributable to outside Members—one-fourth	1,125		
Parent Company's proportion, carried to contra.	£3,375		
Proportion of Losses of A Ltd. attributable to outside Members—			
Profit and Loss Account (as above)		1,125	
Goodwill (as above)		2,000	
		3,125	
Less B Ltd. Capital Reserve, per contra		2,250	
			875
			£503,125

	Parent Ltd.		*A Ltd.*		*B Ltd.*	
	£	£	£	£	£	£
Share Capital—Ordinary Shares of £1 each fully paid		200,000		100,000		50,000
5% First Mortgage Debentures						55,000
Capital Redemption Reserve Fund						10,000
Share Premium Account (Premium on issue of 50,000 Shares issued in payment for 75,000 Shares in A Ltd.)		25,000				
Sundry Creditors		80,000		40,000		20,000
Bills Payable (issued to Parent Ltd.)				16,000		
Profit and Loss Account—						
Balance on 1st January	31,250				8,000	
Add—*Interim Dividend from B Ltd.*	3,750					
Profit for year to date	40,000				17,000	
		75,000			25,000	
Less *Interim Dividend of 20%*					10,000	
						15,000
		£380,000		£156,000		£150,000

	Parent Ltd.		*A Ltd.*		*B Ltd.*	
	£	£	£	£	£	£
Goodwill, at Cost		3,000		18,000		
Land, Buildings, Plant and Machinery at Cost		44,000		40,000		35,000
Investments, at cost—						
75,000 *Shares in A Ltd.*	75,000					
25,000 " *B Ltd.*	50,000					
		125,000				
25,000 " *B Ltd.*				50,000		
10,000 " *X Ltd.*						20,000
Stocks, as valued by Company's Officials		50,000		25,000		20,000
Sundry Debtors		90,000		5,000		35,000
Bills Receivable (accepted by A Ltd.)		8,000				
Balances at Bankers		60,000		2,000		40,000
Profit and Loss Account—						
Balance on 1st January			10,000			
Deduct *Interim Dividend from B Ltd.*			3,750			
			6,250			
Add *Loss for year to date*			9,750			
				16,000		
		£380,000		£156,000		£150,000

Note. Parent Ltd. had contingent liabilities in respect of (a) Bills discounted £8,000, and (b) a guarantee of the Debentures issued by B Ltd.

Parent Ltd. and A Ltd. both purchased their Shares in B Ltd. on 1st January of the current year.

Parent Ltd. purchased the 75,000 Shares in A Ltd. on 1st January of the previous year when the debit balance on the latter company's Profit and Loss Account was £8,000.

[*Solution on pages* 354 *and* 355]

Notes. (1) Since the interest of the outside members in the share capital of A Ltd. has been reserved for in full, such members are automatically credited with their one-fourth interest in B Ltd., as the holding in B Ltd. is an asset in A Ltd.'s Balance Sheet. Their interest in the profits of B Ltd. has been adjusted through A Ltd.'s Profit and Loss Account.

(2) It has been assumed that the interim dividend declared by B Ltd. was paid wholly out of the current year's profits.

(3) It will be observed that where one of the subsidiary companies has a debit balance on Profit and Loss Account the adjustments are exactly the converse of those in respect of a credit balance. Thus, a credit on Profit and Loss Account at the date of acquisition of the control is transferred to the *credit* of Capital Reserve, and from thence the proportion applicable to the Holding Company is transferred to the *credit* of Goodwill and the proportion applicable to outside shareholders to the *credit* of Outside Shareholders. Where, however, as in the case of A Ltd., there was a *debit* balance on Profit and Loss Account at the date of acquisition of control, the proportion applicable to the Holding Company is transferred to the *debit* of Goodwill and the proportion applicable to the outside shareholders to the *debit* of outside shareholders.

Similarly, a debit on Profit and Loss Account arising since the acquisition is transferred to the *debit* of the Holding Company's Profit and Loss Account and the outside shareholders respectively.

(4) The amount attributable to Goodwill being the excess of the cost of a holding over the net assets represented thereby, and the net assets representing the nominal capital plus profits and reserves, or less losses, if the Goodwill is visualized in the form of an account it is merely *debited* with the cost of the shares (in addition to any Goodwill already standing in the books) and *credited* with profits or *debited* with losses at the date of acquisition. Thus—

GOODWILL

	£	£		£	£
To Book Values—			By Nominal Value of Shares—		
Parent Co.	3,000		A Ltd.	75,000	
A Ltd.	18,000		B Ltd.	50,000	
		21,000			125,000
„ Cost of Shares in—			„ Premium on Shares, Parent Co.		25,000
A Ltd.	75,000		„ Capital Reserve, B Ltd.		15,750
B Ltd.	100,000		„ Balance		36,250
		175,000			
„ Loss at date of acquisition—A Ltd.		6,000			
		£202,000			£202,000

From the following Balance Sheets, prepare a Consolidated Balance Sheet (ignore Income Tax)

BALANCE SHEETS
31ST DECEMBER, 1936

	H Ltd. £	W Ltd. £
Capital—Authorized, Issued and Fully Paid		
6% £1 Pref. Shares	15,000	8,000
£1 Ord. Shares	20,000	4,000
4½% Debentures	—	5,000
Sundry Creditors	9,200	6,000
Amount due to W Ltd.	300	
Bills Payable		
Drawn by H Ltd.	—	1,000
Others	2,500	500
Reserve	5,000	2,000
Profit and Loss Account	2,300	1,100
Note. *There is a contingent liability on H Ltd. for £900 in respect of Bills. Discounted and not yet matured.*		
	£54,300	£27,600

	£	H Ltd. £	W Ltd £
Goodwill, at cost		6,000	4,000
Fixed Assets, at cost less depreciation			
Buildings		10,000	5,000
Plant and Machinery		12,000	3,000
Furniture and Fittings		1,200	500
Stock-in-trade		8,000	7,000
Sundry Debtors, less Reserve for Doubtful Debts		7,000	4,600
Bills Receivable			
W Ltd.	300		
Others	1100		
		1,400	700
Amount due from H Ltd.			500
Balances at Bank and Cash in Hand		3,000	2,300
Investments in W Ltd., at cost—			
2,000 *Pref. Shares*	2,400		
3,000 *Ord Shares*	3,300		
		5,700	
		£54,300	£27,600

On the date when H Ltd. acquired the shares in W Ltd., the latter's Reserve stood at £1,500 and its Profit and Loss Account had a credit balance of £800. Preference Dividends have been regularly paid up to 30th June, 1936. Ordinary dividends have also been paid regularly up to 31st December, 1935, and the dividends received by H Ltd. have been properly recorded in that company's books; of the first ordinary dividend paid since the date of acquisition of the shares, H Ltd. credited £300 to the "Ordinary Shares in W Ltd. Account." Debenture Interest is paid to date.

At the date of acquisition of the shares, plant standing at £2,400 in W Ltd.'s books was revalued at £2,000, but no adjustment was made in the books. Between that date and 31st December, 1936,

depreciation amounting to 30 *per cent in all has been written off such plant. In the Stock-in-Trade of H Ltd. at* 31*st December,* 1936, *are* £360 *of goods purchased from W Ltd. W Ltd. likewise has in stock goods valued at* £1,280 *which were purchased from H Ltd. In arriving at the price to invoice goods to H Ltd., W Ltd. adds* 20 *per cent to cost price; H Ltd. invoices to W Ltd. at its usual selling price, which results in a net profit percentage of* 12½. *A cheque for* £200, *posted by H Ltd. to W Ltd. on* 31*st December, was received by W Ltd. 2nd January.*

[*For Solution see pages 360 and 361*]

CONSOLIDATED BALANCE SHEET OF H LTD.

AS AT 31ST

	£	£	£
Capital—Authorized, issued and fully paid. H Ltd.			
6% £1 Pref. Shares		15,000	
£1 Ord. Shares		20,000	
			35,000
Capital of W Ltd. attributable to outside shareholders—			
6% £1 Pref. Shares		6,000	
£1 Ord. Shares		1,000	
			7,000
Proportion of undistributed profits attributable to outside shareholdings—			
Capital Reserve(see below)		475	
Reserve do.		125	
Profit and Loss Account do.		160	
		760	
Less Plant over-valuation per contra		100	
		660	
Add Preference dividend accrued		180	
			840
4½% Debentures W Ltd.			5,000
Capital Reserve, being undistributed profits, etc., at date of acquisition of the shares in W Ltd. by H Ltd.			
Reserve W Ltd. (see below)		1,500	
Profit and Loss Account do. do.		400	
		1,900	
Less Proportion attributable to outside shareholdings		475	
Deducted *contra*		1,425	
Sundry Creditors			
H Ltd.		9,200	
W Ltd.		6,000	
			15,200
Bills Payable			
H Ltd.		2,500	
W Ltd.	1,500		
Less held by H Ltd.	300	1,200	
			3,700
Reserve			
H Ltd.		5,000	
W Ltd.	2,000		
Less Balance at date of acquisition of shares transferred to Capital Reserve	1,500		
	500		
Less Proportion attributable to outside shareholdings ¼	125	375	
			5,375
Profit and Loss Account			
H Ltd.	2,300		
Less Unrealized profit on Stock sold to W. Ltd.	120	2,180	
W Ltd.	1,100		
Less Balance at date of acquisition of shares transferred to Capital Reserve, £800 less dividend paid thereout £400	400		
	700		
Less Preference dividend accrued on outside shareholdings	180		
	520		
Add Over-depreciation of plant	120		
	640		
Less Proportion attributable to outside ordinary shareholders ¼	160		
	480		
Less Unrealized profit on Stock sold to H. Ltd.	45	435	
			2,615
			£74,730

AND ITS SUBSIDIARY COMPANY W LTD.

DECEMBER, 1936

			£	£	£
Goodwill—H Ltd.				6,000	
W Ltd.			4,000		
Add Excess of cost of shares over their nominal value					
Cost		£5,700			
Nominal		£5,000			
		700			
Add Amount of over-valuation of Plant at date of acquisition of shares	£400				
Less Proportion attributable to outside shareholders ¼	£100				
		300			
		1,000			
Less Capital Reserve per contra		Cr.1,425	Cr. 425	3,575	
					9,575
Fixed Assets, at cost, less depreciation					
Buildings					
H Ltd.			10,000		
W Ltd.			5,000		
				15,000	
Plant and Machinery					
H Ltd.			12,000		
W Ltd.		£3,000			
Less Amount by which Plant was overvalued on date of acquisition	400				
Less Depreciation thereon to date 30%	120				
		280			
			2,720		
				14,720	
Furniture and Fittings					
H Ltd.			1,200		
W Ltd.			500		
				1,700	
					31,420
Stock-in-Trade					
H Ltd.			8,000		
Less unrealized Profit included in Stock bought from W Ltd. ¾ of [illegible] of £360			45		
				7,955	
W Ltd.			7,000		
Less Unrealized Profit included in Stock bought from H Ltd. ¾ of 12½% of £1,280			120		
				6,880	
					14,835
Sundry Debtors, less Reserves for Doubtful Debts					
H Ltd.				7,000	
W Ltd.				4,600	
					11,600
Bills Receivable					
H Ltd.				1,100	
W Ltd.				700	
					1,800
Balances at Bank and Cash in Hand					
H Ltd.				3,000	
W Ltd.			2,300		
Add Cash in transit			200		
				2,500	
					5,500
					£74,730

(8) *From the following Balance Sheets of the parent and subsidiary companies prepare a consolidated Balance Sheet as at 31st March—*

PARENT CO. LTD.

BALANCE SHEET, 31ST MARCH

Liabilities		£	*Assets*		£
Capital Authorized, Issued and Fully Paid—			*Freehold Land and Buildings, at Cost*		68,700
250,000 *Shares of £1 each*		250,000	*Plant, Fixtures, etc., at Cost, less Depreciation*		2,140
4½% *1st Mortgage Debenture Stock—*			*Investments in Subsidiary Companies, at cost—*	£	
As Issued	£50,000		*A Subsidiary, Ltd.*: 3,760 5% *Pref. Shares of £1 each*	2,820	
Less Purchased and Cancelled to date	44,600		10,000 *Ord. Shares*	10,000	
		5,400	*B Subsidiary, Ltd.*: 5,000 7% *Pref. Shares of £10 each*	50,000	
Loan from B. Subsidiary, Ltd.		19,600	18,800 *Ord. Shares of £10 each*	200,000	
Sundry Trade Creditors, including Taxation Reserve		4,500	*C Subsidiary, Ltd.*: 50,000 *Ord. Shares of £1 each*	54,000	
Reserve for Contingencies		48,463	£1,900 4% *Debenture Stock*	1,500	
General Reserve		75,000			318,320
Profit and Loss Account Balance		23,192	*Advances to Subsidiary Companies—*		
			A Subsidiary Current Account	620	
			B Subsidiary Current Account	47	
					667
			Stocks on Hand		9,360
			Sundry Debtors		4,392
			Cash at Bank		22,576
		£426,155			£426,155

A SUBSIDIARY LTD.

BALANCE SHEET, 31ST MARCH

Liabilities		£	*Assets*	£
Capital Authorized, Issued and Fully Paid—	£		*Freehold and Leasehold Premises at Cost less Depreciation*	7,609
5,000 *Pref. Shares of £1 each*	5,000		*Motor Lorries and Cars at cost, less Depreciation*	24,763
10,000 *Ord. Shares* £1 each	10,000		*Stocks of Petrol, Oil, Spares, etc.*	3,403
		15,000	*Sundry Debtors*	72
Bank Loan		5,000	*Cash at Bank*	119
Advances by Associated Companies		34,165	*Profit and Loss Account*	19,602
Sundry Creditors and Accrued Charges		1,403		
		£55,568		£55,568

B SUBSIDIARY LTD.

Balance Sheet, 31st March

Liabilities		£	*Assets*		£
Capital Authorized, Issued and Fully Paid—	£		*Leasehold Land and Buildings at Cost, less Depreciation*		22,750
5,000 7% Pref. Shares of £10 each	50,000		*Plant, Fixtures etc., at Cost, less Depreciation*		19,475
20,000 Ord. Shares of £10 each	200,000		*Investments—*		
		250,000	*Parent Co., Ltd.*	£47,000	
Sundry Trade Creditors		16,433	*Shares at Cost*	53,000	
Taxation Reserve		19,000	*3½% War Stock*	70,000	
Parent Co. Ltd.—Current Account		47			123,000
Profit and Loss Account		37,429	*Stocks on Hand*		65,960
			Sundry Trade Debtors		44,320
			Parent Co. Ltd.—Advance Account		19,600
			Cash at Bank		27,804
		£322,909			£322,909

C SUBSIDIARY LTD.

Balance Sheet, 31st March

Liabilities	£	*Assets*	£
Capital Authorized, Issued and Fully paid—		*Goodwill, Formulae and Trade-marks at Cost*	34,200
50,000 Ord. Shares of £1 each	50,000	*Development Account — Expenditure to date*	8,799
4% Debenture Stock (secured)	20,000	*Stocks on Hand*	11,201
Sundry Trade Creditors	14,916	*Loan to Associated Company*	33,545
Contingency and Taxation Reserves	9,703	*Sundry Debtors, less Reserves*	17,429
Profit and Loss Account	11,656	*Cash at Bank*	1,101
	£106,275		£106,275

Notes to Consolidated Balance Sheet on p. 364. (1) On the information given, it is impossible to prepare a consolidated balance sheet which will show the full position, e.g. no information is available as to the position of the companies at the respective dates of acquisition of the shareholdings. It has been assumed, therefore, that no profit and loss balances or reserves existed at those dates.

(2) It has been assumed that the preference shares are preferential as to capital.

(3) No information is available as to the arrears of dividend on the A Subsidiary Ltd., preference shares, and no adjustment can therefore be made on this account.

(*Continued on p.* 365)

CONSOLIDATED BALANCE SHEET OF PARENT CO. LTD. AND ITS SUBSIDIARY COMPANIES

As at 31st March

Capital and Liabilities	£	£
Capital, Authorized, Issued and Fully Paid—		
250,000 Shares of £1 each	250,000	
Less Held by B Subsidiary Ltd.	47,000	
		203,000
Share Capital of Subsidiary Companies held by Members outside the combine—		
A Subsidiary Ltd., 1240 5% Pref. Shares of £1 each	1,240	
B Subsidiary Ltd., 1200 Ord. Shares of £10 each	12,000	
		13,240
4½% First Mortgage Debenture Stock, as Issued	50,000	
Less Purchased and Cancelled to date	44,600	
		5,400
4% Debenture Stock (C. Subsidiary Ltd.)	20,000	
Less held by Parent Co. Ltd.	1,900	
		18,100
Undistributed Profits attributable to Members outside the Combine—		
B Subsidiary Ltd.		2,246
Bank Loan, A Subsidiary Ltd.		5,000
Sundry Trade Creditors and Accrued Charges including Taxation Reserve[1]—		
Parent Co., Ltd.	4,500	
A Subsidiary Ltd.	1,403	
B " "	35,433	
C " "	14,916	
[1]*N.B.* The Taxation Reserve of C. Ltd. is not included—see Contingency Reserves		56,252
Reserve for Contingencies—		
Parent Co., Ltd.	48,463	
C Subsidiary Ltd. (including Taxation Reserve)	9,703	
		58,166
General Reserve		75,000
Profit and Loss Account—		
Parent Co. Ltd.	23,192	
B Subsidiary Ltd. £37,429; *Less* Attributable to outside Shareholders 6% 2,246	35,183	
C Subsidiary Ltd.	11,656	
	70,031	
Less A Subsidiary Ltd.	19,602	
		50,429
		£486,833

Assets	Cost £	Nominal £	£	£
Goodwill, Formulæ and Trade-marks, at Cost—				
C Subsidiary Ltd.			34,200	
Excess of Cost of Shares over Nominal Value—				
A Subsidiary Ltd., Pref. Shares	2,820	3,760		
B Subsidiary Ltd, Ord. Shares	200,000	188,000		
C Subsidiary Ltd, Ord. Shares	54,000	50,000		
Parent Co. Ltd., Ord. Shares	53,000	47,000		
	£309,820	288,760	21,060	
			55,260	
Less Excess of Nominal Value of Debentures over Cost			400	
				54,860
Development Account, C Subsidiary Ltd.				8,799
Freehold and Leasehold Land and Buildings at Cost, *less* Depreciation—				
Parent Co. Ltd.			68,700	
A Subsidiary Ltd.			7,609	
B " "			22,750	
				99,059
Plant, Fixtures, etc., at Cost, *less* Depreciation—				
Parent Co. Ltd			2,140	
B. Subsidiary Ltd.			19,475	
				21,615
Motor Lorries and Cars at Cost, *less* Depreciation—				
A Subsidiary Ltd.				24,763
Stocks on Hand—				
Parent Co. Ltd.			9,360	
A Subsidiary Ltd.			3,403	
B " "			65,960	
C " "			11,201	
				89,924
Sundry Debtors, *less* Reserves—				
Parent Co. Ltd.			4,392	
A Subsidiary Ltd.			72	
B " "			44,320	
C " "			17,429	
				66,213
Investments—3½% War Stock				70,000
Cash at Bank—				
Parent Co. Ltd.			22,576	
A Subsidiary Ltd.			119	
B " "			27,804	
C " "			1,101	
				51,600
				£486,833

(4) In the absence of information, it has not been possible to separate the taxation reserves.

(5) It has been assumed that, except as in (3) above, all preference dividends and debenture interest have been paid in full to date.

(6) Some authorities prefer to show the full amount of preference shares as issued capital, bringing in the internal holdings as assets.

The method of preparation already exemplified is that hitherto most generally recognized as the British practice. In all cases, the detailed figures would not be presented to the members, only the totals (i.e. the extensions in the above consolidated Balance Sheets) being disclosed.

Some accountants prefer to prepare the detailed consolidated Balance Sheet in columnar form, based upon the method commonly adopted in the U.S.A. This practice appears to be growing in popularity.

The following inset example should make this clear. The first columns show the Balance Sheets of the companies to be consolidated, then follow the adjustments, and the final column shows the consolidated figures.

The effect is to journalize each adjustment, and if thought desirable the actual Journal entries can be made. Readers will appreciate that in this example, the result would have been arrived at more quickly by the methods already described. Where, however, there are several companies in the group, the columnar method may be much quicker, since separate schedules will be drawn up for assets and liabilities.

SCHEDULE FOR PREPARATION OF CONSOLIDATED PROFIT AND LOSS ACCOUNT

	H.		A.		B.		Minority Shareholders		Total Consolidated Balance Sheet
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	
	£	£	£	£	£	£	£	£	
Balance—per Accounts		5000		1200		2000			
Pref. Dividend (Gross) . .		540			1080			540	
Share of Balance A 33⅓%			400					400	
B 20 %					184			184	
Profits at date of acquisition attributable to shares bought by H. in A 66⅔%			(*l*)400						
B 80 %					(*l*)1040				
Unrealized Stock Profit					(*m*) 96				
		5540	800	1200	2400	2000		1124	Combine £5540
Balances c/f .	5540		400			400	1124		Minority 1124
	£5540	£5540	£1200	£1200	£2400	£2400	£1124	£1124 (*g*)	

EXPLANATIONS OF ADJUSTMENTS

(*a*) To eliminate nominal values of Preference Shares held internally.

(*b*) To eliminate nominal value of ordinary Shares held internally.

(*c*) Holding companies capital extended, being the capital of the group.

(*d*) Minority capital extended.

(*e*) Minority interest in Reserve of B at date of acquisition.

(*f*) Minority interest, amount added since acquisition to reserve of B.

(*g*) Minority interest in profits of subsidiaries.

(*h*) To eliminate inter-company debt.

(*j*) To eliminate inter-company bills.

(*k*) Reserve at date of acquisition (see transfer therefrom in (*e*)).

(*l*) Elimination of H's proportion of profits at date of acquisition.

(*m*) Elimination of unrealized inter-company profit on stock held—80 per cent of £120.

(*n*) Transfer to Goodwill of premium paid on acquisition of Preference Shares.

(*p*) Transfer to Goodwill of premium paid on acquisition of Ordinary Shares in A.

(*q*) Transfer to Goodwill of capital reserve on acquisition of Ordinary Shares in B.

(*r*) Transfer to Investments of £500 excess of revaluation over book value at date of acquisition (Capital Reserve).

(*t*) Transfer to Minority of their share of (*r*).

CHAPTER XIV

LIQUIDATION

ACCOUNTS in Liquidation—Statements of Affairs—Books and Accounts —Returns

BEING a creation of the law, a company can only cease to exist by the processes laid down by law. The Companies Act, 1929, provides two modes by which the company can be brought to an end, viz. by being struck off the register as defunct, or by being removed from the register on the completion of winding-up by the method provided in the Act.

If the Registrar of Companies has reason to believe that a company is not carrying on business or is not in operation, he may send to the company by post a letter inquiring whether the company is carrying on business or is in operation. If he does not within one month of sending the letter receive any answer, he must, within fourteen days after the expiration of the month, send to the company a registered letter referring to the first letter and stating that no answer has been received, and that if an answer is not received to the second letter within one month from its date, a notice will be published in the *Gazette* with a view to striking the name of the company off the register.

If he receives an answer that the company is not carrying on business or is not in operation, or receives no answer within the month, he may publish in the *Gazette* and send to the company by post

a notice that at the expiration of three months from the date of that notice the name of the company will, unless cause is shown to the contrary, be struck off the register, and the company will be dissolved.

If, where a company is being wound up, the Registrar has reason to believe that no liquidator is acting or that the affairs of the company are fully wound up, and that the returns required to be made by the liquidator have not been made for a period of six consecutive months, the Registrar must publish in the *Gazette* and send to the company or the liquidator, if any, a like notice to that mentioned in the last preceding paragraph.

At the expiration of the time mentioned in the notice, the Registrar may, unless cause to the contrary is shown by the company, strike its name off the Register, and must publish notice thereof in the *Gazette*. On publication in the *Gazette* of the notice the company is dissolved. Provision is made for continuing the liability of directors and officers and for restoring the company on the register within twenty years if the Court thinks fit. (S. 295.)

LIQUIDATING A "LIVE" COMPANY

Where the company is "alive," however, the process of liquidation has to be followed. Liquidation or winding-up is the process whereby a liquidator is appointed to close the affairs of the company, collect its assets, and divide them among its creditors in accordance with the Act, any assets remaining after paying the creditors in full being divided among the share or stockholders in accordance with their respective rights.

Form No. 22 (Rule 50)

STATEMENT OF AFFAIRS

(*Title*)

STATEMENT OF AFFAIRS on the   day of   19   , the date of the Winding-up Order.
(Or such other date as the Official Receiver has for special reasons directed.)

I.—*As regards Creditors.*

Gross Liabilities			Liabilities				Expected to Rank			Assets				Estimated to Produce		
£	s.	d.					£	s.	d.					£	s.	d.
			Debts and liabilities, viz.—							(a) Property as per List "H," viz.—						
			(a) . . . Unsecured Creditors as per List "A" (State number)							(a) Cash at Bankers						
										(b) Cash in hand						
										(c) Stock-in-trade . . . . . . (Estimated cost, £)						
				£	s.	d.				(d) Machinery						
			(b) . . . Creditors fully secured (not including debenture holders), as per List "B"							(e) Trade fixtures, fittings, utensils, etc. . .						
			Estimated value of securities .							(f) Investments in shares, etc. . . .						
										(g) Loans on mortgage						
										(h) Other property, viz.—						
			Estimated surplus . . £							(b) Book debts (debtors), as per List "I," viz.—						
			Carried to List "C"							Good						
			Balance to contra (d) . . . . £								£	s.	d.			
			(c) . . . Creditors partly secured as per List "C" . . . . £							Doubtful						
			Less estimated value of securities							Bad						

			Estimated to rank for dividend				Estimated to produce			
			(*d*) Liabilities on bills discounted other than Company's own acceptances for value, as per List "D" Of which it is expected will rank for dividend .				(*c*) Bills of exchange or other similar securities on hand. as per List "J" . . . . . Estimated to produce			
			(*e*) Other liabilities, as per List "E" . . . Of which it is expected will rank for dividend .				(*d*) Surplus from securities in the hands of creditors fully secured (per contra) (*b*) . . .			
			(*f*) . . . Preferential Creditors for rates, taxes, wages, etc., as per List "F" deducted contra . . £ | £ | s. | d.				(*e*) Unpaid calls (debtors), as per List "K" . . . . . . £ s. d. Estimated to produce			
							Estimated total assets			
			(*g*) Loans on debenture-bonds, as per List "G" deducted contra (holders) . . . . . . £				*Deduct* preferential Creditors as per contra (*f*) Estimated amount available to meet claims of debenture holders . . . . *Deduct* loans on debenture bonds secured on the assets of the Company as per contra (*g*) .			
			£				Estimated amount available to meet unsecured Creditors, subject to cost of liquidation . . .			
			Estimated surplus (if any) after meeting liabilities of company, subject to cost of liquidation . .				Estimated deficiency of assets to meet liabilities of the company, subject to cost of liquidation . . .			
			£				£			

The nominal amount of unpaid capital liable to be called up is £ which is [available to meet above deficiency] or [charged to debenture holders], or as the case may be.

FORM No. 22—*continued*

STATEMENT OF AFFAIRS

II.—*As regards Contributories*

		£	s.	d.	£	s.	d.		£	s.	d.
	Capital issued and allotted, viz.—							Estimated Surplus as above (if any), subject to cost of Liquidation . . .			
(*a*) Where capital is issued as partly paid up the form should be altered accordingly.	Founders' Shares of £ per share (Shareholders.) (*a*) Issued as fully paid. Amount called up at £ per share, as per List "L" .										
	Ordinary Shares of £ per share (Shareholders.) (*a*) Issued as fully paid. Amount called up at £ per share, as per List "M" .										
	Preference Shares of £ per share (Shareholders.) (*a*) Issued as fully paid. Amount called up at £ per share, as per List "N" .										
(*b*) Add particulars of any other capital.	(*b*)										
	Amount (if any) paid in advance of calls . . .										
	£										
	Less unpaid calls estimated to be irrecoverable . . . £										
	Add deficiency to meet liabilities as above							Total deficiency as explained in Statement "O" . .			
	£							£			

I, of make oath and say that the foregoing Statement and the several Lists hereunto annexed marked are, to the best of my knowledge and belief, a full, true, and complete statement of the affairs of the above-named Company, on the day of 19 , the date of the winding-up order (*a*).

NOTE.—*The Commissioner is particularly requested, before swearing the Affidavit, to ascertain that the full name, address and description of the Deponent are stated, and to initial all crossings-out or other alterations on the printed form. A deficiency in the Affidavit in any of the above respects will entail its refusal by the Court, and will necessitate its being re-sworn.*	Sworn at in the County of this day of 19 Before me	Signature.

A Commissioner, etc.

(*a*) Where the Official Receiver has directed any date other than the date of the Winding-up Order, substitute such other date.

LIST "O" (1)

Deficiency Account

(1) Deficiency Account where Winding-up Order (i) made within Three Years of Formation of Company

	£	s	d
I. Gross profit (if any) arising from carrying on business from date of formation of Company to date of Winding-up Order (1) (as per Trading Account annexed)			
II. Receipts (if any) during same period from under-mentioned sources—			
Interest on Loans			
Interest on Deposits			
Transfer Fees			
Amount paid on Shares issued and subsequently forfeited (as per List annexed)			
III. Other receipts (if any) during same period not included under any of the above headings, viz.			
IV. Deficiency as per Statement of Affairs—Part II			

	Amount Discharged £	s.	d.	Due at Date of Winding-up Order £	s.	d.	£	s.	d.
I. Expenditure in carrying on business from date of formation of Conpany to date of Winding-up Order, (1) viz.—									
II. General Expenditure—									
Salaries									
Wages not charged in Trading Account									
Rent									
Rates and Taxes									
Law Costs									
Commission									
Interest on Loans									
Interest on Debentures									
Miscellaneous expenditure (as per details annexed)									

				III. Directors' fees from date of formation of Company to date of Winding-up Order (1) . .				
				IV. Dividends declared during same period . .				
				V. Losses and depreciation written off in Company's books (2)— Bad Debts . . . . / Losses on Investments . . . . . . / Depreciation on Property . . . . . / Preliminary Expenses				
				VI. Losses and depreciation not written off in Company's books, now written off by the Directors (2)— . . Bad Debts . . . . / Losses on Investments . . . . . . / Depreciation on Property . . . . . / Preliminary Expenses				
				VII. Other Losses and Expenses				
Total amount to be accounted for . . . (3) £				Total amount accounted for . . . . (3) £				

NOTES.—(1) Where the Official Receiver has so directed substitute any other date.
(2) Where particulars are numerous they should be inserted in a separate Schedule.
(3) These figures should agree.

Signature

Dated 19 .

LIST "O" (2).

Deficiency Account.

(2) DEFICIENCY ACCOUNT WHERE WINDING-UP ORDER (i) (1) MADE MORE THAN THREE YEARS AFTER FORMATION OF COMPANY.

	£	s.	d.
I. Excess of Assets over Capital and Liabilities on the (2) day of 19 (if any) as per Company's Balance Sheet. (This and any previous Balance Sheets to be annexed or handed to O.R.) . . .			
II. Gross profit (if any) arising from carrying on business from the (2) day of 19 , to date of Winding-up Order (1) (as per Trading Account annexed)			
III. Receipts (if any) during same period from under-mentioned sources—			
Interest on Loans			
Interest on Deposits			
Transfer Fees			
Amounts paid on Shares issued and subsequently forfeited (as per List annexed)			
IV. Other receipts (if any) during the same period not included under any of the above headings . . .			
V. Deficiency as per Statement of Affairs (Part II) .			

	Amount Discharged			Due at Date of Winding-up Order (1)			£	s.	d.
I Excess of Capital and Liabilities over Assets on the (2) day of 19 (if any), as per Company's Balance Sheet. (This and any previous Balance Sheets to be annexed or handed to O.R.) .									
II. Expenses of carrying on business from the (2) day of 19 , to date of Winding-up Order (1), viz.—									
	£	s.	d.	£	s.	d.			
General Expenditure—									
Salaries .									
Wages not charged in Trading Account .									
Rent . .									
Rates and Taxes .									
Law Costs . .									
Commission . .									
Interest on Loans .									
Interest on Debentures									
Miscellaneous expenditure (as per details annexed) . .									

	£				£		
				III. Directors' Fees from the (2) day of 19 , date of Winding-up Order (1) . .			
				IV. Dividends declared during same period . .			
				V. Losses and depreciation from the day of 19 (2), written off in Company's books, viz. (3)—			
				Bad Debts			
				Losses on Investments			
				Depreciation of Property			
				Preliminary Expenses			
				VI. Losses and depreciation not written off in Company's books, now written off by Directors (3)—			
				Bad Debts			
				Losses on Investment			
				Depreciation of Property			
				Preliminary Expenses			
				VII. Other Losses and Expenses (3)			
Total amount to be accounted for . . . (4) £				Total amount accounted for . . . (4) £			

NOTES.—(1) Where the Official Receiver has so directed substitute any other date.
(2) Three years before date of Winding-up Order or such other date as the Official Receiver has directed.
(3) Where particulars are numerous they should be inserted in a separate schedule.
(4) These figures should agree.

Signature

Dated 19 .

13—(B.C.154)

VOLUNTARY LIQUIDATION

Winding up may be voluntary or compulsory. A voluntary liquidation is one brought about by the company itself without the intervention of the Court. If the company is solvent, the directors may file a declaration that in their opinion the company will be able to pay its debts in full within a year, in which case the voluntary liquidation is a "members' voluntary winding-up," free from direct control by the creditors. In any other case, the liquidation will be a "creditors' voluntary winding-up," and the creditors have direct control. A voluntary liquidation may, in appropriate cases, be continued under supervision of the Court, on application being made.

COMPULSORY LIQUIDATION

A compulsory winding-up is one brought about by an order of the Court made as a result of a winding-up petition presented by the company, creditors, or contributories.

In a voluntary winding-up, some form of a statement of the affairs of the company is usually placed before the members, and (if it is a creditors' voluntary winding-up) the creditors, but no particular form is prescribed, although it is usual in practice to follow approximately the form required in compulsory liquidation.

In a compulsory winding-up, a statement of affairs in the prescribed form must be submitted to the Official Receiver within fourteen days from the winding-up order (or from the appointment of a provisional liquidator where one is appointed) by one or more of the directors or officers, etc.

NAME OF COMPANY: .. .. LIMITED........

(*Registered Office:*)

STATEMENT OF AFFAIRS

as at the day of , 19

(I) AS REGARDS CREDITORS

Gross Liabilities £ s. d.	Liabilities	Estimated by the Officers of the Company to Rank £ s. d.	Assets	Estimated by the Officers of the Company to Produce £ s. d.
	Unsecured creditors ( ) £ s. d.		Cash at Bankers	
			Cash in Hand	
	Creditors fully secured ( ) (not including Debenture Holders) .		Stock-in-trade (estimated cost £) . .	
			Machinery (cost £) .	
			Trade fixtures, fittings, utensils, etc.	
	Estimated value of securities . .		Other property, viz.—	
	Estimated surplus to contra (*a*) . . £		Book debts (debtors), viz.— Good . . . £ s. d.	
	£ s. d. Creditors partly secured ( ) .		Doubtful . .	
	Less estimated value of securities . .		Bad . . . £	
	Estimated to rank for Dividend .		Estimated to produce .	
	£ s. d. Preferential creditors for rates, taxes, wages, etc. ( ) deducted contra (*b*) . . .		Bills of Exchange, or other similar securities on hand, estimated to produce . .	
			Surplus from securities in hands of creditors fully secured (per contra) (*a*)	
			Unpaid Calls . . £ s. d. (debtors) .	
			Estimated to produce .	
	£ s. d. Loans on Debenture Bonds (holders) deducted contra (*c*) . .		Estimated total assets . .	
			Deduct preferential creditors (per contra) (*b*) . . .	
	Other liabilities of which it is expected will rank for Dividend		Estimated amount available to meet claims of Debenture Holders	
			Deduct Loans on Debenture Bonds per contra (*c*) . .	
			Estimated amount to meet unsecured creditors, subject to cost of liquidation . .	
			Estimated deficiency of assets to meet liabilities of the Company, subject to cost of liquidation	
	£		£	

(II) As Regards Contributories

	£	s.	d.		£	s.	d.
Capital issued and allotted, viz.— Ordinary Shares of per Share (Shareholders) Called up at per Share . . . Preference Shares of per Share (Shareholders) Called up at per Share . . . Add deficiency to meet Liabilities as above .				Total deficiency . .			
£				£			

Dated the .... *day* *Signed*
of................ . . 19

STATEMENT OF AFFAIRS

The form of Statement of Affairs in compulsory winding-up is given on pages 370–377.

In voluntary winding-up, a Statement is usually prepared in the form given on pages 379–380; no form is however prescribed.

The Statement reproduced is supported by schedules, giving the details which make up the totals shown thereon, and for examination purposes candidates are expected to be able to reproduce the Statement as shown, including, in some cases, the Deficiency Account. It has not been thought necessary to reproduce the schedules.

The following notes will facilitate the preparation of these statements—

(1) The Statement of Affairs and the Deficiency Account enable the double entry to be completed. If a trial balance or complete list of balances is given in a question, students must therefore be sure to give effect to the double entry in every adjustment. The purpose of the Deficiency Account is to explain how the deficiency disclosed by the Statement of Affairs has arisen. If an asset

is expected to realize less than its book figure, the depreciation must be charged in the Deficiency Account. If any asset is included which was formerly the subject of a secret reserve, it must be brought in as an increase in the Deficiency Account. Similarly, if a liability expected to rank for dividend is not in the list of balances, it must be brought in as a "loss" in the Deficiency Account.

(2) All assets are included at the prices they are estimated to produce in the hands of the liquidator, which presupposes a forced sale. Note that the cost price of stock in trade is inset.

(3) The lay-out of the book debts should be observed. The amount written off in the Statement must appear in the Deficiency Account.

(4) In the unsecured creditors must be included all the debts which are not appropriate to any other heading.

(5) The fully secured creditors include all those holding security valued at an amount equal to or greater than their debts. To be a secured creditor, the creditor must hold security given by the company. The transfer of the surplus should be noted.

(6) The partly secured creditors include all those holding security of a value less than their debts. If partly secured creditors have a second charge on securities held by fully secured creditors, the excess of the value of such securities over the amount of the fully secured debts is deducted from the partly secured debts. Any surplus of securities which are not charged to partly secured creditors is transferred to contra.

(7) The preferential debts are inset on the liabilities side, and deducted from the assets, since the aim is to show what amount of assets is finally available for creditors.

(8) Debenture bonds are similarly treated, being deducted from the assets *after* the preferential creditors have been deducted, so as to show the net amount of assets available for unsecured creditors.

(9) The treatment of unpaid calls should be noted. These are represented by a debit balance on the books. So far as this is expected to be collected, the amount is brought in as an asset. The balance (the amount *not* expected to be recovered) is deducted from the called-up capital in the Statement as regards contributories, so that there is left as ranking on the latter only the amount which members will have paid to the company on their shares.

PREFERENTIAL DEBTS

The preferential debts are as follows—

(*a*) All parochial or other local rates due from the company at the relevant date [i.e. the date of the winding-up order (in the case of compulsory liquidation) or the date of the commencement of the winding-up, i.e. of passing the resolution to wind up (in voluntary winding-up)], and having become due and payable within twelve months next before that date.

It should be remembered that local rates are legally due immediately they are made by the local authority so that if a demand note is served on the company a short time before the relevant

date, the claim would rank preferentially even though, as is probable, the rate covers a period which ends at a subsequent date.

(*b*) All assessed taxes, land tax, property or income-tax assessed on the company up to 5th April next before that date, and not exceeding in the whole one year's assessment. (Where there are several years' taxes outstanding, the Inland Revenue are entitled to choose which year's tax shall be claimed as preferential.)

(*c*) All wages or salary (whether or not earned wholly or in part by way of commission) of any clerk or servant in respect of services rendered to the company during four months before the relevant date, not exceeding £50.

Directors cannot claim preferentially in respect of their fees. If the secretary of the company devotes the whole or a specific part of his time in the performance of his duties, he ranks as a servant for any unpaid salary, but if he does the work involved in his own time, e.g. where another company is appointed to perform secretarial services, he ranks as an ordinary creditor for any remuneration outstanding.

(*d*) All wages of any workman or labourer not exceeding £25, whether payable for time or piece work, in respect of services rendered to the company during two months next before the relevant date.

Where a person has advanced money to meet wages or salary, he is subrogated to the rights which the employee would have had.

Where, however, any labourer in husbandry has entered into a contract for the payment of a portion

of his wages in a lump sum at the end of the year of hiring, he has priority in respect of the whole of such sum, or a part thereof, as the Court may decide to be due under the contract, proportionate to the time of service up to the relevant date.

(*e*) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or of amalgamation with another company, or unless the company has at the commencement of the winding-up under such a contract with insurers as is mentioned in Section 7 of the Workmen's Compensation Act, 1925, rights capable of being transferred to and vested in the workmen, all amounts due in respect of any compensation or liability for compensation under that Act, accrued before the relevant date.

Where the company is insured, the workman whose claim for compensation has been sustained, can look to the Insurance Company for payment and has therefore no claim against the company whose employee he is unless the latter is underinsured. In such a case, any balance of the claim would seemingly rank as an unsecured debt.

Should any party have a claim against the company in respect of a risk against which the company is insured, such party is entitled to have his claim paid out of the money due from the Insurance Company under the Third Parties (Rights Against Insurers) Act, 1930, his position being similar to that of a workman in respect of a compensation claim.

Where any compensation under the Workmen's Compensation Act is a weekly payment, the

amount due is taken as the lump sum for which the weekly payment could be redeemed.

(*f*) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or of amalgamation with another company, all amounts due in respect of contributions payable during the twelve months next before the relevant date by the company as the employer of any persons under the National Health Insurance Acts, the Widows', Orphans' and Old Age Contributory Pensions Act, or the Unemployment Insurance Acts.

Where a receiver is appointed, the relevant date is the date of his appointment or of possession being taken by or on behalf of the debenture-holders unless the company is already in liquidation, when, of course, the liquidation date applies.

STATEMENT OF RECEIPTS AND PAYMENTS

If a voluntary liquidation is not completed within one year, the liquidator must send to the Registrar of Companies within thirty days from the end of the first year, and thereafter at half-yearly intervals statements of his receipts and payments in the following form.

(It should be noted that the liquidation is not deemed to be completed until the name of the company is actually struck off the Register, and as this ordinarily takes place at the expiration of three months after the Registrar has received notice of the final meeting having been held, if the active proceedings are not concluded until after nine months from the date of the commencement, the liquidation will be deemed to have taken more than a year, and the Return will have to be filed.)

Number of Company .... Form No. 92 (Rules 194, 195, and 198)

[*Re* . . . . *Limited.* ....

This is the Exhibit marked "B" referred to in the Affidavit of

....

sworn before me this.. ... ... day of ...., 19

....

A Commissioner for Oaths.]

STATEMENT OF RECEIPTS AND PAYMENTS, AND GENERAL DIRECTIONS AS TO STATEMENTS.

Name of Company.. ....

1. Every Statement must be on sheets 13 inches by 16 inches. **Size of Sheets.**

2. Every Statement must contain a detailed account of all the Liquidator's Realizations and Disbursements in respect of the Company. The Statement of Realizations should contain a record of all Receipts derived from Assets existing at the date of the Winding-up Resolution and subsequently realized, including Balance in Bank, Book Debts and Calls Collected, Property Sold, etc.; and the Account of Disbursements should contain all payments for costs and charges, or to creditors or contributories. Where property has been realized, the gross proceeds of sale must be entered under Realizations, and the necessary payments incidental to sales must be entered as Disbursements. These accounts should not contain payments into the Companies Liquidation Account (except Unclaimed Dividends, *see paragraph* 5), or Payments into or out of Bank, or Temporary Investments by the Liquidator, or the proceeds of such investments when realized, which should be shown separately— **Form and contents of Statement.**

(*a*) By means of the Bank Pass Book;
(*b*) By a separate detailed Statement of Moneys Invested by the Liquidator, and Investments Realized.

Interest allowed or charged by the Bank, Bank Commission, etc., and profit or oss upon the realization of Temporary Investments should, however, be inserted n the Accounts of Realizations or Disbursements, as the case may be. Each receipt and payment must be entered in the account in such a manner as sufficiently to explain its nature. The receipts and payments must severally be added up at the foot of each sheet, ***and the totals carried forward from one Account to another without any intermediate balance, so that the gross totals shall represent the total amounts received and paid by the Liquidator respectively.***

3. When the Liquidator carries on a business, a Trading Account must be forwarded as a distinct Account, and the Totals of Receipts and Payments on the Trading Account must alone be set out in the Statement. **Trading Account.**

4. When Dividends or Instalments of Compositions are paid to Creditors, or a Return of Surplus Assets is made to Contributories, the total amount of each Dividend, or Instalment of Composition, or Return to Contributories, actually paid must be entered in the Statement of Disbursements as one sum; and the Liquidator must forward separate accounts showing in lists the amount of the claim of each creditor and the amount of dividend or composition payable to each creditor, and of surplus assets payable to each contributory, distinguishing in each list the dividends or instalments of composition and shares of surplus assets actually paid, and those remaining unclaimed. Each list must be on sheets 13 inches by 8 inches. **Dividends, etc.**

5. When unclaimed Dividends, Instalments of Compositions, or Returns of Surplus Assets are paid into the Companies Liquidation Account, the total amount so paid in should be entered in the Statement of Disbursements as one sum.

6. Credit should not be taken in the Statement of Disbursements for any amount in respect of Liquidator's remuneration, unless it has been duly allowed by resolution of the Committee of Inspection or of the Creditors, or of the Company in General Meeting, or by order of Court as the case may require.

LIQUIDATOR'S STATEMENT OF ACCOUNT

Pursuant to Section 284 *of The Companies Act*, 1929.

Name of Company ....

Nature of Proceedings ....
(whether a Members' or Creditors' Voluntary Winding Up or a Winding Up under the Supervision of the Court)

Date of Commencement of Winding-up ....

Date to which Statement is brought down ....

Name and Address of Liquidator ....

....

This Statement is required in duplicate, and must be accompanied by an Affidavit verifying same (Form No. 93)

ANALYSIS OF BALANCE

				£	s.	d.
TOTAL REALIZATIONS					:	:
„ DISBURSEMENTS					:	:
BALANCE				£	:	:
The Balance is made up as follows—				£	s.	d.
1. Cash in hands of Liquidator					:	:
2. Total Payments into Bank, including Balance at date of commencement of Winding Up (*as per Bank Book*)	£	s.	d.			
		:	:			
Total Withdrawals from Bank . . .		:	.			
Balance at Bank					:	:
3. Amount in Companies Liquidation Account						:
	£	s.	d.			
4. Amounts invested by Liquidator[1] . .		:	:			
Less Amounts realized from same . .		:	:			
Balance					:	:
TOTAL BALANCE as shown above				£	:	:

[NOTE.—Full details of Stocks purchased for investment and of realization thereof should be given in a separate Statement.]

[1] The investment or deposit of money by the Liquidator does not withdraw it from the operation of Section 285 of The Companies Act, 1929, and any such investments representing money held for six months or upwards must be realized and paid into the Companies Liquidation Account, except in the case of investments in Government Securities, the transfer of which to the control of the Board of Trade will be accepted as a sufficient compliance with the terms of the Section.

NOTE.—The Liquidator should also state—

1. The Amount of the estimated Assets and Liabilities at the date of the commencement of the Winding-up . .	Assets	after deducting Amounts charged to Secured Creditors and Debenture Holders	£	:	:
	Liabilities	Secured Creditors .	£	:	:
		Debenture Holders .	£	:	:
		Unsecured Creditors .	£	:	:
2. The Total Amount of the Capital paid up at the date of the commencement of the Winding-up	Paid up in Cash		£	:	:
	Issued as paid up otherwise than for Cash		£	:	:
3. The General Description and Estimated Value of Outstanding Assets (if any)					
4. The Causes which delay the Termination of the Winding-up .					
5. The Period within which the Winding-up may probably be completed					

LIQUIDATOR'S STATEMENT OF ACCOUNT PURSUANT TO

REALIZATIONS

Date	Of whom Received	Nature of Assets Realized	Amount £	s.	d.
		Brought forward . .			
		Carried forward . . £			

This margin is reserved for binding, and should not be written across.

NOTE.—No balance should be shown on this Account, but only the total

SECTION 284 OF THE COMPANIES ACT, 1929

DISBURSEMENTS

This margin is reserved for binding, and should not be written across.

Date	To whom Paid	Nature of Disbursements	Amount £	s.	d.
		Brought forward . .			
		Carried forward . . £			

Realizations and Disbursements, which should be carried forward to the next Account.

LIQUIDATOR'S CASH BOOK

In compulsory liquidation the liquidator must keep a Cash Book in the following form—

COMPULSORY LIQUIDATION
CASH BOOK

Receipts									Payments																			
														Costs of Realization														
Date	Particulars	Total	Drawn from Bank	Debts Collected	Property Realized	Receipts from Securities held by Creditors	Calls	Other Receipts	Date	Particulars	Voucher Nos. (in red)	Total	Paid into Bank	Board of Trade and Court Fees	Law Costs of Petition	Law Costs after Winding-up Order	Remuneration of Manager and Liquidator	Official Receiver's Commission on Assets Realized, and Amount Distributed in Dividend or Paid to Contributories	Charges of Auctioneer, Accountant, Shorthand Writer, etc., as taxed	Notices in *Gazette* and Local Paper	Incidental Expenses, including Possession	Preferential Creditors and Rent	Payments to redeem Securities	Dividends Paid	Repayments to Contributories	Other Payments
		£	£	£	£	£	£	£				£	£	£	£	£	£	£	£	£	£	£	£	£	£	£

Where a business is carried on the liquidator must also keep a distinct Trading Account in the following form—

Number of Company .... [Form No. 94.

"THE COMPANIES ACT, 1929"

LIQUIDATOR'S TRADING ACCOUNT

Under Section 284 *of The Companies Act*, 1929, *and pursuant to Rules* 194 *and* 198 *of The Companies (Winding Up) Rules*, 1929

Insert here the Name of the Company. .... LIMITED,

Insert here the Name of the Liquidator. ....

the Liquidator of the above-named Company in account with the Estate.

This Account is required in duplicate in addition to Form 92.

Presented by

....

....

RECEIPTS

Dr.

Date		£	*s.*	*d.*
	Brought forward . .			
	Carried forward . . £			

This margin is reserved for binding, and should not be written across.

PAYMENTS

Cr.

Date		£	s.	d.
	Brought forward . .			
	Carried forward . . £			

This margin is reserved for binding, and should not be written across.

(Date ....*Liquidator*

When the winding-up is complete, the liquidator must lay before the final meeting an account showing the manner in which the winding-up has been conducted and the property of the company disposed of. This usually takes the following form—

LIQUIDATORS' FINAL STATEMENT OF ACCOUNT

showing how the Winding-up of . . . . *Limited,* has been conducted and the property of the Company has been disposed of.

[MEMBERS'] [CREDITORS'] VOLUNTARY WINDING-UP

From . 19 *to* 19

Dr. *Cr*

Receipts from Date of Commencement of Winding-up	RECEIPTS £	s.	d.	Payments from Commencement of Winding-up	PAYMENTS £	s.	d.
To Receipts—				By Costs of Solicitor to Liquidator . .			
Cash at Bankers . .				„ Other Law Costs . .			
Cash in hand . .				„ Liquidators' Remuneration			
Stock-in-trade . .				„ Auctioneers' and Valuers' Charges . . .			
Machinery, etc. . .				„ Costs of possession and maintenance of Estate			
Trade Fixtures . .				„ Costs of Notices in *Gazette* and local papers .			
Investments . .				„ Incidental Out of Pockets			
Loans on Mortgage, etc.				„ Other Charges . .			
Book debts . . .							
Bills of Exchange . .							
Surplus from Securities .							
Receipts per Trading Account							
Other Receipts . .							
Total				Total Costs and Charges .			
Less (£ s. d.)				(£ s. d.)			
Payments to redeem Securities				Debenture-holders			
Costs of Execution . . .				Creditors			
Payments per Trading Account				[1]Preferential:			
				[1]Unsecured: Dividend of s. d. in the £ on £ .			
Net Realization . . . £				Amount returned to Contributories			
Amounts received from Calls on Contributories in the winding-up . . .							
£				£			

[1] State number of creditors.

Illustrations. (1) *The Auto Delivery Company Limited went into voluntary liquidation on 31st August.*

From the following particulars prepare the Statement of Affairs which would be submitted to meetings of creditors and contributories.

The subscribed capital consisted of—

10,000 7% *Cumulative Preference Shares of £1 each, fully paid.*
5,000 *Ordinary Shares of £1 each, fully paid.*
5,000 ,, ,, ,, 15*s. paid.*

It was known that the amount uncalled was irrecoverable.

The dividend on the Preference Shares was two years in arrear.

The assets comprised—

	Book Value	Estimated Value
	£	£
Land and Buildings	4500	3000
Motor Vans	5650	3200
Machines and Tools	1200	500
Furniture and Fittings	975	325
Stores and Spares	1460	810
Debtors—Good	600	600
Doubtful	500	300
Bad	150	—

The liabilities were—

	£
Bank Overdraft (secured by deposit of the deeds of the land and buildings and the personal guarantees of the directors)	3250
Service Motor Co. Ltd., for overhauling van	65
(They claim a lien on the van which cost £400 and is valued at £200.)	
Unsecured Creditors	6130
Preferential Creditors	80

AUTO DELIVERY COMPANY LTD.
(in voluntary liquidation)

STATEMENT OF AFFAIRS ON 31ST AUGUST

(I) As Regards Creditors

Gross Liabilities	*Debts and Liabilities*		Expected to Rank	*Assets*		Estimated to Produce
£		£	£			£
6130	Unsecured Creditors .		6130	Property—		
65	Creditors fully secured	65		Stores and Spares . . .		810
	Estimated value of securities . . .	200		Machines and Tools . . .		500
				Motor Vans		3000
				Furniture and Fittings . .		325
	Surplus to *contra* .	£135		Book Debts—		
				Good		600
3250	Creditors partly secured	3250		Doubtful	£500	
				Bad	£150	
	Less estimated value of securities . .	3000			£450	
			250			
80	Preferential Creditors, deducted *contra* .	£80		Estimated to produce . .		300
				Surplus from securities in the hands of creditors fully secured . .		135
				Estimated Total Assets . .		5670
				Deduct Preferential Creditors as per *contra*		80
				Estimated amount available to meet unsecured creditors, subject to cost of liquidation		5590
				Estimated deficiency . . .		790
£9525			£6380			£6380

The nominal amount of unpaid capital liable to be called up is £1,250, which is known to be irrecoverable.

(II) As Regards Contributories

	£		£
Capital issued and allotted, viz.—			
10,000 7% Cum. Pref. Shares of £1 each, fully paid . . .	10,000		
5000 Ord. Shares of £1 each, fully paid	5,000		
5000 Ord. Shares of £1 each, 15s. paid	3,750		
	18,750		
Add Deficiency to meet liabilities as above	790	Total Deficiency . . .	19,540
	£19,540		£19,540

Note.—Unless the Articles contain any provisions on the point, Preference shareholders have no claim in respect of

arrears of dividends. The question, however, would not arise in this case, as there is a deficiency as regards creditors.

(2) *The Balance Sheet of WP Co. Ltd., on* 31*st December,* 1936, *showed the position of that company to be as under—*

Liabilities	£	*Assets*	£
Issued Share Capital—		*Freehold Property* . .	24,000
7% Cum. Pref. Shares, fully paid . .	15,000	*Stock*	9,250
Ord. Shares, fully paid	10,000	*Sundry Debtors* . .	12,500
Deferred Shares of £1 each 10s. paid . .	5,000	*Cash*	4,000
Sundry Creditors . .	6,750		
General Reserve . .	5,000		
Profit and Loss Account .	8,000		
	£49,750		£49,750

Owing to a falling off in the demand for the company's goods resulting from the invention of a cheaper substitute, the Directors, with the sanction of the Shareholders, entered into a contract for the sale of the assets as they stood on 31*st December,* 1936. *The company resolved to go into voluntary liquidation on* 1*st January,* 1937. *After completion of sale, payment of debts and provision for expenses of liquidation, the sum of £*34,000 *was available for distribution. All dividends on Preference Shares had been paid to* 31*st December,* 1935, *this class of share being preferential as to capital, whilst the Ordinary and Deferred Shares rank* pari passu *in the event of winding-up.*

Show the manner in which the Liquidator should distribute the assets.

The exact distribution of the sum in the hands of the liquidator between the three classes of shareholders will be dependent upon the precise terms

of the company's Memorandum and Articles of Association.

(*a*) If the company's Articles provide that the preference dividend shall not be paid until recommended by the directors, then, unless a resolution of the Board to pay the dividend for 1936 has been passed, the arrears cannot be claimed from the liquidator. (*Crichton's Oil Co.*)

If, however, the declaration of the preference dividend is not within the discretion of the directors, but becomes payable automatically when profits are available, the preference shareholders may claim one year's dividend from the liquidator.

(*b*) Unless the company's Memorandum or Articles provide to the contrary, the preference shareholders will be entitled to share *pro rata* with the other shareholders in any surplus arising after all capital has been repaid. (*William Metcalfe & Sons.*)

Assuming that no resolution to pay the preference dividend for 1936 had been passed and that there are no provisions in the Articles as to the manner in which any surplus arising on the winding-up is to be disposed of, the sum of £34,000 remaining in the liquidator's hands will be applied as follows—

	£
Repayment of Preference Share Capital . . .	15,000
,, Ordinary Share Capital . . .	10,000
,, Deferred Share Capital . . .	5,000
Surplus divided *pro rata* between 15,000 Preference Shares, 10,000 Ordinary Shares, and 10,000 Deferred Shares = 35,000 Shares at 2/3.43 per Share .	4,000
	£34,000

Note.—In the absence of express provisions in the Articles, the surplus remaining after the repayment of capital in full is

divisible among the shareholders in proportion to the nominal amount of share capital held by them respectively and not in proportion to the amount paid up on the shares. (*Birch v. Cropper.*)

(3) *The books of Accessories Ltd. at* 31*st July contained the following balances—*

	£	£
Share Capital—		
20,000 *Shares of* £1 *each paid*		20,000
Sundry Creditors		15,000
Plant and Machinery	6,000	
Stock	4,000	
Patent Rights and Trade Marks	16,000	
Sundry Debtors	6,000	
Preliminary Expenses	500	
Profit and Loss Account	2,475	
Cash	25	
	£35,000	£35,000

The following scheme of reconstruction was submitted to the shareholders and creditors—

The company to go into Voluntary Liquidation and a new company with a nominal capital of £40,000 *to be formed to take over all the assets from the Liquidator on the following terms—*

(*a*) *Preferential Creditors for* £500 *to be paid in full.*

(*b*) *Unsecured Creditors to have the option of receiving cash for* 10s. *in the* £ *in full settlement of their claims or par value in* 7½ *per cent Debentures in the new company.*

(*c*) 20,000 *shares of* £1 *each,* 10s. *per share paid to be distributed pro rata to shareholders of the old company.*

(*d*) *The new company to pay the costs of the Liquidation.*

One half of the unsecured creditors exercised their option to be paid in cash, and the funds for this and

for payment of the liquidation expenses (which amounted to £300) were obtained by calling up the balance of 10s. per share.

Three shareholders holding 1,500 *shares dissented and required their interests to be purchased. The price of* 6s. 8*d. was agreed upon and was paid to the liquidator by one of the assenting shareholders in return for the transfer of such shares.*

Prepare the Liquidator's Account for presentation to the Final Meeting of Members.

LIQUIDATOR'S FINAL STATEMENT OF RECEIPTS AND PAYMENTS

Receipts	£	£	*Payments*	£	£
To Realization of Assets—			By Cash Payments—		
Cash in hand .	25		Liquidation Expenses .	300	
Cash from New Company for Payment of Creditors and Expenses	4,400		Preferential Creditors .	500	
Cash from New Company for purchase of 1500 Shares from dissentient Shareholders at 6s. 8d. per Share .	500		Unsecured Creditors, 10s. in £ on £7250	3,625	
		4,925	Dissentient Shareholders: 1500 Shares at 6s. 8d. per share .	500	4,925
" 7½% Debentures in New Company . . .		7,250	" Unsecured Creditors for £7500—7½% Debentures in New Company		7,250
" 20,000 £1 Shares, 10s. paid up in New Company . . .		10,000	" Assenting Shareholders 20,000 Shares of £1 each, 10s. paid, being 1 Share in New Company for every Share in Old Company .		10,000
		£22,175			£22,175

Here would follow a full statement of the scheme, as set out in the question.

Notes: (1) There is no statutory form of a Liquidator's Final Statement of Account ~~in~~ Voluntary Liquidation for presentation at the final meeting of members, but the above form follows Form 92, which is required under *Section* 284, *Companies Act*, 1929, with the exception that it includes, not only the cash, but also the debentures and shares received on sale of the business to the new company.

(2) The call of 10s. per share would be made by the new company after the allotment of the shares, and would not appear in the Liquidator's Statement of Account.

(4) *Contractors Limited went into Voluntary Liquidation on 1st July, at which date the dividend on its Preference Shares was one year in arrear.*

The Subscribed Capital of the Company consisted of—

10,000 6% *Cumulative Preference Shares of £1 each, fully paid, which were preferential both as regards Dividends and Capital.*
20,000 *Ordinary Shares of £1 each* (12*s*. 6*d*. *per Share called and paid up*).
15,000 *Ordinary Shares of £1 each* (15*s*. *per Share called and paid up*).

The Assets realized £26,275, the costs and expenses of Liquidation were £1150, and the Creditors' Claims amounted to £22,000.

Set out the Liquidator's final Statement of Account as it would appear assuming that he was able to get in all the cash due from Shareholders in respect of such calls as he found it necessary to make.

CONTRACTORS LIMITED
(IN VOLUNTARY LIQUIDATION)

LIQUIDATORS' FINAL STATEMENT OF RECEIPTS AND PAYMENTS.

For submission to the meeting of members called for... 19....

Receipts	£	*Payments*	£
Proceeds of Sale of Assets	26,275	Costs and Expenses of Liquidation	1,150
Proceeds Call of 5s. per share on 20,000 Ord. Shares	5,000	Creditors	22,000
Proceeds Call of 2s. 6d. per share on 15,000 Ord. Shares	1,875	Return of Capital on 10,000 6% Pref. Shares of £1 each	10,000
	£33,150		£33,150

Note.—Although the Preference Shares were preferential as to dividend, it is not stated that arrears were due to be paid in the event of a winding up; unless the memorandum or articles provide for the payment of such arrears, they are not payable.

(5) *The M Co. Ltd. ceased to trade on 31st October, 1936, when effective resolutions were passed for the voluntary winding-up of the company and a Liquidator was appointed. The balances in the books on that date were as follows—*

		£
Issued Capital—		
10,000 6% *Pref. Shares of £1 each, fully paid*		10,000
5000 *Ord. Shares of £1 each, 10s. paid up*		2,500
5% *Debentures*		2,000
Loan (guaranteed by Directors)		3,000
Sundry Creditors—		
Trade Creditors:		
Z. Works Ltd.	£1000	
Others	8000	
	9000	
Inland Revenue	1350	
Managing Director for Salary for October	150	
Employees for Salaries for October (none over £50)	280	
		10,780
		£28,280

		£
Furniture, at cost		720
Investments, at cost		17,000
Life Assurance Policy		1,300
Sundry Debtors—		
B Ltd.	£500	
Others	7500	
		8,000
Balance at Bankers		900
Profit and Loss Account		360
		£28,280

The loan creditor called upon the Directors to implement their guarantees, which they did. The Preference Dividend was payable half-yearly and the dividend due 30*th June,* 1936, *had been paid. The Debentures were not mortgage debentures and there were no arrears of interest. The amount owing to the Inland Revenue was in respect of three unpaid assessments, viz.* 1934–35 £250, 1935–36 £1,050, and 1936–37 £50.

The employees were all dismissed on 31*st October,* 1936, *and the Liquidator admitted claims, amounting to* £210, *for salaries in lieu of notice.*

The landlord had been paid by the company up to 31*st October,* 1936; *the premises were held on a yearly tenancy but the landlord agreed to waive his right to notice on the Liquidator undertaking to pay him two months' rent* (£50), *and to vacate the premises by* 31*st December,* 1936, *which he did.*

Z Works Ltd. were under contract to deliver certain goods to the company in December, 1936, *while the company had contracted to supply these goods to B Ltd. The Works refused to make delivery but admitted a claim made by the Liquidator for* £125

damages. A claim for loss was made by B Ltd. against the Liquidator and admitted by him at the sum of £75.

The Liquidator realized £600 for the furniture. The investments were of no value. Sums owing by debtors were all collected and the policy was sold for £1,200 after the Liquidator had paid a further premium of £45.

A shareholder who held 2,000 Ordinary Shares failed to pay the call of 10s. a share made by the Liquidator.

The Liquidator's remuneration was £500. He paid £60 for legal advice.

Prepare the Liquidator's account of Receipts and Payments, showing the dividend paid to creditors and the order in which payments should be made.

LIQUIDATOR'S STATEMENT OF ACCOUNT

Realizations	£	£	*Disbursements*	£
To Cash at Bankers		900	By Law Costs	60
„ Furniture		600	„ Costs—Premium on Life Policy	45
„ Investments		—	„ Remuneration of Liquidator	500
„ Debtors—			„ Preferential Creditors	1,330
B. Ltd.	500		„ Landlord — Compromise *re* Waiver of Notice	50
Less Claim for Breach of Contract set-off	75		„ Unsecured Creditors—Dividend of 14s. 0.05d. in £ on £14,660	10,265
		425		
Others		7,500		
„ Life Assurance Policy		1,200		
„ Z Ltd.—Damages for Breach of Contract		125		
„ Call made by Liquidator, 10s. per Share on 5000 Shares	2,500			
Less Calls unpaid on 2000 Shares	1,000			
		1,500		
	£	12,250	£	12,250

Notes. (1) The Preferential Creditors are as follows—

	£
Income-tax, 1935–36	1,050
Employees' Salaries	280
	£1,330

(2) The Unsecured Creditors are as follows—

	£
Debentures	2,000
Trade Creditors	9,000
Income-tax, 1934–35 and 1936–37	300
Managing Director	150
Employees for Salaries in lieu of Notice	210
Directors in respect of Loans met under their guarantee	3,000
	£14,660

(3) With regard to the claims for damages for breach of contract, it is doubtful whether these could be set off on the grounds of mutual dealings, since the breach of the contracts did not take place until after the date of the resolutions for the winding-up of the company. It is considered, however, that in the case of the breach by the liquidator, it would have been one of the terms on which B Ltd. would have agreed to the compromise that the amount of the claim admitted by the liquidator should be set off against the debt owing to the company by B Ltd., and this has been assumed.

Apart from any question of agreement as to set-off in settling the claims for breach of contract, however, it would depend upon the exact facts as to whether set-off would be legally enforceable.

(4) Since the question states that the debentures were not mortgage debentures, it is assumed that they carry no charge, either fixed or floating, over any of the assets of the company.

(6) *The Tottering Transport Company Limited went into voluntary liquidation on 31st May.*

From the following particulars prepare the Statement of Affairs which would be submitted to meetings of creditors and contributories.

The subscribed capital consisted of—

10,000 *7 per cent Cumulative Preference Shares of £1 each, fully paid.*
5,000 *Ordinary Shares of £1 each, fully paid.*
5,000 *Ordinary Shares of £1 each, 15s. paid.*

The dividend on the Preference Shares was two years in arrear.

The assets comprised—

	Book Value	Estimated Value
	£	£
Land and Buildings	4,500	3,000
Motor Vans	5,650	3,200
Machines and Tools	1,200	500
Furniture and Fittings	975	325
Stores and Spares	1,460	810
Debtors—Good	600	600
Doubtful	500	300
Bad	150	—

The liabilities were—

	£
Bank Overdraft (secured by deposit of the deeds of the land and buildings and the personal guarantees of the directors)	3,250
Service Motor Co Ltd., for overhauling van.	65
(They claim a lien on the van which cost £400, and is valued at £200.)	
Unsecured Creditors	6,130
Preferential Creditors	80

TOTTERING TRANSPORT COMPANY LTD
(in voluntary liquidation)

Statement of Affairs on 31st May

(1) As Regards Creditors

Gross Liabilities	*Debts and Liabilities*		Expected to Rank	*Assets*		Estimated to Produce
£		£	£			£
6,130	Unsecured Creditors		6,130	Property—		
65	Creditors fully secured	65		Stores and Spares		810
	Estimated value of securities	200		Machines and Tools		500
				Motor Vans		3,000
	Surplus to *contra*	£135		Furniture and Fittings		325
				Book Debts—		
				Good		600
3,250	Creditors partly secured	3,250		Doubtful	£500	
	Less estimated value of securities	3,000		Bad	150	
			250		£650	
80	Preferential Creditors, deducted *contra*	£80		Estimated to produce		300
				Surplus from securities in the hands of creditors fully secured		135
				Estimated Total Assets		5,670
				Deduct Preferential Creditors *per contra*		80
				Estimated amount available to meet unsecured creditors, subject to costs of liquidation		5,590
				Estimated deficiency		790
£9,525			£6,380			£6,380

The nominal amount of unpaid capital liable to be called up is £1,250.

(2) As Regards Contributories

	£		£
Capital issued and allotted, viz.—			
10,000 7% Cum. Pref. Shares of £1 each, fully paid	10,000		
5000 Ord. Shares of £1 each, fully paid	5,000		
5000 Ord. Shares of £1 each, 15s. paid	3,750		
	18,750		
Add Deficiency to meet liabilities as above	790	Total deficiency	19,540
	£19,540		£19,540

Note.—Unless the Articles contain any provisions on the point, Preference shareholders have no claim in respect of arrears of dividends. The question, however, would not arise in this case, as there is a deficiency as regards creditors.

(7) *On the 1st January, 1935, the Cardiff Enamel and Foundry Co. Ltd. went into voluntary liquidation and on the same day a Receiver was appointed by the Debenture-holders, under the powers of an instrument which gave a floating charge only.*

The position as at the commencement of the liquidation was as follows—

		£	£		£
Paid-up Capital—				*Freehold Land and Buildings*	21,245
10,000 *Pref. Shares of £1 each*		10,000		*Debtors*	6,500
15,000 *Ord. Shares of £1 each*		15,000		*Finished and Partly Finished Stocks*	3,500
			25,000	*Plant and Machinery, Muffles and Motor Vehicles*	5,000
6% *Debentures*		10,000		*Goodwill, Patterns and Formulae*	3,500
Interest accrued		300		*Profit and Loss Account*	6,750
			10,300		
Sundry Creditors—					
Trade Debts—Ordinary		3,000			
Income tax—					
1933–4	£3000				
1934–5	1000				
		4,000			
Trade Debts—Crown		250			
Rates		200			
Workmen's Compensation		100			
Electricity		45			
			7,595		
Midland Bank, Ltd.			3,600		
			£46,495		£46,495

The Receiver disposed of the whole of the book debts for £5,750, and made his obligatory payments.

His remuneration was 5 per cent on the amount realized by him, and 3 per cent on the amounts paid to creditors. He duly paid over the balance of cash to the Liquidator after deducting out-of-pocket expenses amounting to £125.

The remaining assets realized the following amounts—

	£
Freehold Land and Buildings	40,000
Finished and Partly Finished Stock	2,500
Motor Vehicles	2,000
Goodwill, Patterns and Formulae	8,750

In the event of liquidation the Preference Shareholders were entitled to 10 per cent of any surplus, after discharging liabilities and costs, the balance belonging to the Ordinary Shareholders.

Prepare Accounts of the Receiver and Liquidator showing the receipts and payments made by them.

RECEIVER'S RECEIPTS AND PAYMENTS ACCOUNT

Receipts	£	s.	d.	*Payments*	£	s.	d.
To Realization of Book Debts	5,750	0	0	By Expenses of Receivership	125	0	0
				„ Receiver's Remuneration—			
				5% on £5,750 £287 10 0			
				3% on £3,300 99 0 0			
					386	10	0
				„ Preferential Creditors—			
				Income-tax, 1933–4 £3,000			
				Rates . . . 200			
				Workmen's Compensation . . . 100			
					3,300	0	0
				„ Balance to Liquidator .	1,938	10	0
	£5,750	0	0		£5,750	0	0

LIQUIDATOR'S RECEIPTS AND PAYMENTS ACCOUNT

Receipts	£	s.	d.	*Payments*		£	s.	d.
To Balance received from Receiver . . .	1,938	10	0	By Expenses of Liquidation .			?	
„ Freehold Land and Buildings . . .	40,000	0	0	„ Liquidator's Remuneration			?	
„ Finished and Partly Finished Stock . .	2,500	0	0	„ 6% Debentures	£10,000			
„ Motor Vehicles . .	2,000	0	0	Interest thereon	300	10,300	0	0
„ Goodwill, Patterns, and Formulae . . .	8,750	0	0	„ Sundry Creditors—				
				Trade, Ordinary	£3,000			
				Trade, Crown .	250			
				Income-tax, 1934–5 .	1,000			
				Electricity . .	45			
				Midland Bank .	3,600	7,895	0	0
				„ Preference Shareholders— Return of				
				Capital .	£10,000 0 0			
				10% of Surplus .	1,199 7 0	11,199	7	0
				„ Ordinary Shareholders— Return of				
				Capital .	£15,000 0 0			
				Surplus .	10,794 3 0	25,794	3	0
£	55,188	10	0	£		55,188	10	0

Notes. (1) The Receiver's obligatory payments are the preferential creditors. With regard to income-tax, only one year's income-tax assessed up to the preceding 5th April is preferential, the remaining assessment being unsecured.

(2) The distribution to the shareholders is subject to the liquidator's expenses and remuneration, particulars of which are not given.

DISTRIBUTION OF SURPLUS, ETC.

Any surplus remaining in the hands of the liquidator, after paying all creditors in full, must be divided among the contributories according to their rights and interests. For this purpose, it may be necessary to make calls on some classes of shareholders. The surplus must be applied—

(1) In repaying the paid-up capital. Shareholders having preferential rights as to capital must be paid off before those with inferior rights.

(2) In a distribution to those shareholders entitled to share what is left after repaying capital.

To determine the rights of members, it is necessary to inspect the Memorandum and Articles of Association, so as to arrive at the respective rights of the different classes of members. When a person becomes a member of a company, he thereby becomes entitled to a proportionate part of the assets and profits, unless the Memorandum or Articles provide otherwise. The fact that a preference shareholder is given special rights, e.g. to a preferential return of capital, does not deprive him of other rights as a shareholder, unless the Memorandum or Articles contain express provisions to that effect.

Accordingly, unless there is a contrary provision in the Memorandum or Articles, the surplus assets remaining, after paying all debts and liabilities and repaying all the capital paid up on all classes of shares, are distributable rateably among the holders of all classes of shares, and do not belong to one class, e.g. ordinary shareholders, only. Preference shareholders are only precluded from sharing where the construction of the Memorandum and Articles negatives their right to do so. (*In re Metcalfe & Sons* (1933), Ch. 142.)

Where preference shareholders are preferential as to dividends, the holders are not entitled in the liquidation to any arrears of dividend unless such dividends have been declared (*Crichton's Oil Co.* (1902), 2 Ch. 86) or the Articles contain an express provision to the effect that such arrears are to be made good. (*Bridgewater Navigation Co.* (1891), 2 Ch. 317.)

If, however, the Memorandum or Articles provide that in a winding-up the preference

shareholders are entitled, after the repayment of their capital, to have the surplus assets applied in paying off any arrears of preferential dividends, the right is enforceable even where no profits have ever been earned by the company. (*In re Springbok Agricultural Estates* (1920), 1 Ch. 563.) In this respect, if the Memorandum or Articles speak of "arrears of dividend due," it must be remembered that a dividend is not due until declared, and if no dividend has been declared, such a provision would not entitle the preference shareholders to "arrears" of dividend. (*In re Roberts and Cooper* (1929), 2 Ch. 383.)

Arrears of dividend paid as part of the distribution of surplus in a winding-up are not liable to income-tax, being a distribution of capital. (*Dominion Tar and Chemical Co* (1929), 2 Ch. 387.) Amounts paid in advance of calls are repayable *before* the amounts called up on the shares, but if calls have to be made in the course of the winding-up, such payments in advance will, of course, be appropriated towards the calls.

Calls in arrear should be collected. If the amounts due cannot be collected, the shares will normally be forfeited.

Illustrations. (1) *The capital of a company consisted of—*

30,000 £1 *Preference Shares,* 15*s. paid and*
50,000 £1 *Ordinary Shares,* 10*s. paid.*

After paying all debts, liabilities and costs, there remained £3,500 to distribute. The Memorandum and Articles were silent as to surplus. Show how the liquidator should distribute the amount available.

Since the regulations are silent, all shareholders must suffer rateably. Accordingly, the distribution must proceed as follows—

	£
Amount available.	3,500
If there were called up 5s. per share on the ordinary shares to make them paid up equally with the preference shareholders, this would produce. .	12,500
There would then be available for distribution . .	£16,000

Divided between the holders of 80,000 shares, this would enable the liquidator to return 4s. per share. There would be no point in calling up 5s. and repaying 4s.; all that is necessary is to call up 1s. per share on the ordinary shares.

The distribution will thus be as follows—

	£		£
To Cash in hand	3,500	By Repayment of 4s. per share on 30,000 Pref. Shares . .	6,000
„ Call of 1s. per share on 50,000 Ord. Shares	2,500		
	£6,000		£6,000

Each shareholder has thus lost 11s. per share in the company.

(2) *Taking the same figures as in the previous illustration, assume that the preference shares are preferential as to capital.*

	£
Amount required to repay preference capital. .	22,500
Deduct cash in hand	3,500
Deficiency	£19,000

This amount must be called up from the ordinary members, involving a call of 7s. 7·2d. per share.

The distribution will thus be as follows—

	£		£
To Cash in hand	3,500	By Repayment of 15s. per share on 30,000 Pref. Shares , .	22,500
„ Call of 7s. 7·2d. per share on 50,000 Ord. Shares . .	19,000		
	£22,500		£22,500

(3) *The capital of a company consisted of—*

25,000 £1 *Preference Shares fully paid.*
100,000 £1 *Ordinary Shares 12s. 6d. paid.*

The regulations of the company gave a preference as to capital, but were silent as to any surplus. After paying all debts, liabilities and costs, the liquidator had in hand £110,000. Show the distribution.

	£		£
To Cash in hand	110,000	By Repayment of paid up Capital	
		Preference	25,000
		Ordinary	62,500
		„ Distribution of Surplus—3s. 7·2d. per share to holders of 125,000 shares	22,500
	£110,000		£110,000

Had the preference shareholders been expressly debarred from sharing in surplus, the whole £22,500 would have been shared between the ordinary shareholders, giving them 4s. 6d. per share.

(4) *The capital of a company comprised—*

50,000 *Preference Shares of £1 each, 16s. paid.*
200,000 *Ordinary Shares of 2s. each, 1s. paid.*
20,000 *Deferred Shares of 6d. each, fully paid.*

The Memorandum of Association provided that in a winding-up the Preference Shareholders should be repaid their capital in preference to all other classes of shares, but contained no provisions as regards the capital of other classes.

After collecting the assets, the liquidator found that there was a deficiency of £2,000 in the amount required to pay the debts, liabilities and costs. Show the adjustment among the shareholders.

	£		£
To Call of 1s. per share on the ordinary shareholders	10,000	By amount employed to meet balance of debts, etc.	2,000
		„ Repayment of 3s. 2·2d. per share on 50,000 Pref. Shares	8,000
	£10,000		£10,000

(5) *A company had the following capital—*

30,000 £1 6 per cent Preference Shares, fully paid .		£30,000
20,000 10s. Ordinary Shares, 7s. 6d. called	£7500	
Less calls in arrear on 400 shares	50	
		7,450
Calls in advance on 600 shares		75
10,000 1s. Deferred Shares, 6d. paid . . .		250

Preference dividends had been paid up to 2½ years prior to the commencement of the winding-up.

The Memorandum and Articles of Association provided that in a winding-up (1) *the preference shareholders were to be preferential as to capital, and the ordinary shareholders should be repaid before the deferred shareholders, and* (2) *preference dividends were to be paid up to the commencement, whether declared or not.*

All calls were duly met, except those on 300 ordinary shares (part of the 400 on which calls were already in arrear), and these shares were forfeited.

After paying the debts, etc., the liquidator had in hand £32,137 5*s.* 10d. *Show the distribution.*

Note. In such a case, it is advisable to work out the position assuming that all the capital was called up, so as to see how much really needs to be called.

If all capital were called up in full—

	£ s. d.	£ s. d.
Balance in hand		32,137 5 10
Proceeds of call on 19,700 Ordinary Shares, 2s. 6d. per share . .	2,462 10 0	
Less calls in advance . .	75 0 0	
	2,387 10 0	
Add calls in arrear on 100 shares, now collected . . .	12 10 0	
		2,400 0 0
Proceeds of call on 10,000 Deferred Shares, 6d. per share		250 0 0
		£34,787 5 10

If this amount were available, there could be paid—

	£	s.	d.
"Arrears" of preference dividend .	4,500	0	0
Preference Capital	30,000	0	0
Ordinary Capital 3½d. per share on 19,700 shares	287	5	10
	£34,787	5	10

It is therefore only necessary to call up 2s. 2½d. per share (2s. 6d.—3½d.), and the distribution will be as follows—

	£	s.	d.		£	s.	d.
To Balance in hand . .	32,137	5	10	By "Arrears" of Pref. Dividends, 15% on 30,000 £1 shares	4,500	0	0
" Calls in arrear on 100 Ord. Shares now collected, 2/6 per share . . .	12	10	0	" Repayment of 30,000 £1 Pref. Shares . . .	30,000	0	0
" Call of 2s. 2½d. per share on 19,100 Ord. Shares . .	2,108	19	2	" Repayment of 3½d. per share paid in advance on 600 Ord. Shares . .	8	15	0
" Call of 6d. per share on 10,000 Def. Shares . .	250	0	0				
£	34,508	15	0	£	34,508	15	0

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